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Le Bureau publie aussi *European Taxation,* revue mensuelle sur les systèmes fiscaux européens. *Tax News Service,* publié deux fois par mois, donne une information rapide, à l'échelle mondiale, de tout ce qui touche à la fiscalité. *Supplementary Service to European Taxation* est un ouvrage de référence présentée sous feuilles mobiles.

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Le Budget du Pakistan pour l'année fiscale 1982/83 ..... *15*

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Har Govind:

Contributions aux partis politiques effectuées en Inde par les sociétés – Limites légales et pièges fiscaux – *21*

L'auteur étudie le traitement des contributions versées aux partis politiques qui sont théoriquement interdites mais peuvent être possible sous des formes déguisées. Toutefois ces contributions ne sont pas normalement déductibles en matière d'impôt sur le revenu et sont en général soumises aux droits sur les donations.

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Edward Andersson:

Finlande: Lois sur l'impôt sur les sociétés prises comme instruments de politique économique: quelques expériences finnoises *35*

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Income Tax Reform in Developing Countries: The Administrative Dimension *

By Richard M. Bird

This paper begins with a brief section emphasizing the central importance of administration in income tax reform. The next two sections then discuss the central ingredients of any expanded and improved income tax in a developing country – a full withholding and current payment system, and a systematic use of standard assessment techniques. The former is the principal way the collection and enforcement problem is dealt with everywhere – not just in developing countries – and the latter probably offers the best way to cope with the overwhelming problems facing the characteristically understaffed and undertrained tax administration in countries where most potential taxpayers do not keep reliable books and records (or, if they do, cannot be induced or compelled to reveal them to the authorities). The final section of the paper discusses more briefly a few other important administrative aspects that seem central to the possibility of improving the income tax system in any developing country.

Although the discussion in the present paper focuses on the income tax, and particularly on the personal income tax, much of what is said here seems equally applicable to all other "modern" taxes, by which I mean taxes that are in principle based on accounts and records (such as the sales tax) as well as taxes based on valuations (such as the property tax). The "presumptive" technique described below, for example, is as often used for sales taxes as for income taxes. Similarly, the value-added tax may be characterized as a form of "withholding" intended to implement a retail (or other) sales tax more efficiently. There is also a strong parallel between the rationale and working of the standard assessment techniques discussed below and the "mass appraisal" methods often proposed for property tax purposes: in both cases, the administrative essence of the system is the development by experts of a detailed manual which can then be applied by non-experts to individual cases. Only when taxes are based directly on easily identifiable and verifiable characteristics – as is the case with most excise taxes for example – can most of the problems discussed here be avoided. Although only the income tax is discussed here, many of the arguments are therefore in principle much wider in scope.

Currently Professor of Economics and Director of the Institute for Policy Analysis, University of Toronto, Richard Bird has previouysly taught at Harvard and Toronto, served as an advisor in Colombia and as chief of the Tax Policy Division of the International Monetary Fund, and has acted as a consultant in fiscal matters in many developing countries. He has also written extensively on public finance and development.

I. THE IMPORTANCE OF ADMINISTRATION

A central task of the tax system in any country is obviously to collect revenues. Another task, however, is to distribute the cost of financing the government fairly among taxpayers in the interests both of distributive justice and of improving public acceptance of the unpleasant necessity of taxation. The key to implementing any concept of "fair" taxation, however, lies in the ability of the tax administration to reach all those who should pay tax and to tax them in accordance with their (socially-determined) ability to pay. Since in most countries the main tax which attempts to be "fair" in this sense is the income tax, the importance of effective income tax administration as the keystone of an acceptable tax system cannot be overstressed. The point here is not only that the income tax is one of the few taxes that permit distinctions to be made among taxpayers in accordance with their personal circumstances, but also that its effects – its "fairness", or otherwise – are particularly visible. The development of an effective personal tax administration is thus an important goal of tax reform – and its absence in most developing countries establishes severe constraints on what can, or should, be done in the way of substantive tax reform.

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* An earlier version of this paper was presented to the "IIème Colloque sur Fiscalité et Développement", Paris, September 1982.

For these reasons, it is therefore critically important in proposing changes in tax policy to be sure that such changes do not require a higher order of administrative capability than exists. If they do, the changes will either not, in the end, be implemented or, if implemented, they will in all likelihood fail, or have unforeseen (and often undesired) effects. It is equally important, on the other hand, to ensure that such changes are conducive to strengthening and improving the tax administrative machinery over the long run – as well as to reinforcing the desired general direction of tax policy, rather than counteracting it.

The key to a good personal tax system in most countries is thus good income tax administration. Good income tax administration in turn requires a favourable political environment, in the sense of a government that, from the highest level down, has the desire and authority to enforce the tax. Even if this essential prerequisite is satisfied – as must simply be *assumed* in what follows – there will remain serious administrative problems arising from the economic structure of a typical developing country. Many of these problems are potentially solvable, however, as discussed below. In the absence of firm and consistent political support for the revenue authorities over a substantial period of time, however, no basic improvements can be expected in tax administration. Since without some such improvement, it is not really possible to implement a good personal tax system, no matter how well designed that system might be on paper, it is simply assumed in the remainder of this paper that political conditions are favourable to the sorts of administrative methods discussed. If this assumption is *not* correct, as may well be the case in many countries, tax reform efforts would be more profitably directed at designing and implementing effective indirect, impersonal means of generating the requisite revenues than in refining the essentially ineffective and inequitable system of taxing persons in accordance with their income.

The three "E's" of tax administration

The three basic tasks of any tax administration are to *identify* potential taxpayers, to *assess* the appropriate tax on them and to *collect* that tax. In other words, the "three E's" of administering taxes are to *enumerate, estimate,* and *enforce.* All of these tasks are much more difficult to accomplish in a developing country, where many potential taxpayers are not enmeshed in the set of interlocking recorded transactions characteristic of developed countries. In all countries, it is much harder to tax self-employed businessmen, farmers, and professionals than it is to tax employees of large organizations. It is yet another of the misfortunes of developing countries that so much more of their potential tax base lies in the former group that they perforce need to spend relatively more of their scarce resources on the inherently difficult task of taxing them.

Unfortunately, there are no shortcuts to better tax administration. The best a developing country can do with respect to the "hard-to-tax" is to emulate what is done in developed countries with respect to the same groups: namely, so far as possible to collect the taxes before they have a chance to hide the income (through a withholding system), to assess taxes on the basis of something more readily verifiable than income (through an estimation system), and, of course, to enforce the tax system as rigorously as possible. The balance of this paper essentially elaborates these three points.

The Institute for Policy Analysis is a graduate centre at the University of Toronto intended to facilitate quantitative and policy research on economic and social questions, primarily by Toronto faculty. Institute Associates (approximately thirty in number) are all appointed in other university departments, particularly economics. The role of the Institute is primarily to facilitate research by providing computer and office support to Associates and by aiding them in securing grant or contract funding. In addition, the Institute, through its Policy and Economic Analysis Program (P.E.A.P.), maintains online two national econometric models – Focus, a quarterly national policy model, and Prism, a provincial-industrial satellite model which provides regional and sector breakdowns of national aggregates. A number of government departments and private corporations subscribe to the P.E.A.P. program, thus facilitating continued developmental work in policy modeling.

A "global" income tax has an equity and economic rationale

First, however, it should perhaps be emphasized that it is *assumed* throughout this discussion that a principal policy aim is to make the income tax more effectively global. A "global" income tax, one that aggregates income from all sources at the level of the individual (or family) and subjects it to a single, progressive rate schedule, has both an equity and an economic rationale. In equity terms, it is widely accepted that income, broadly defined, provides a suitable basis for "fair" personal taxation. Only a truly global income tax – one that as far as possible distinguishes among people in respect only to the *amount* of income that they receive rather than the form in which they happen to receive it – is really satisfactory in this respect. Similarly, only such a tax, properly constructed and administered, can avoid distorting the pattern of economic activity, usually in an undesired fashion, by diverting resources into relatively lightly-taxed activities. The attainment of this ideal is difficult in any country, let alone a developing country with a relatively fragmented economic structure. Some compromise in both policy design and administration is therefore almost inevitable. But what is important is that any necessary compromises should be explicitly identified and recognized as such, and not incorporated into the tax structure as basic elements of the tax system.

An example may make the point clearer. Recognizing that it is much easier to reach employment income than income from self-employment, for instance, many countries have tried to offset the apparent injustice to wage-earners (who find it harder to evade) by imposing higher tax rates on non-wage income, in the mistaken belief that such differential rates will somehow, in the end, result in a "fairer" system.[1] The mistake in this approach is twofold: first, because of the belief that rate differentials "offset" the administrative difficulties of tapping the "hard-to-tax", the need to improve tax administration is generally neglected; secondly, partly because administration is not improved, evasion – now even more rewarding than before because of the higher rates – will tend to escalate to offset the differential. The usual result of differential rates intended to recognize the greater probability that certain types of income evade the tax net is thus to increase the probability of this outcome.

Tinkering with a rate structure cannot compensate for the absence of a good administrative structure

The more general lesson is that no amount of tinkering with the rate structure (or other elements of tax design) can compensate for the absence of a good administrative structure – although some tax designs can certainly make the task of any administration easier than others. There are no "quick fixes", technological or otherwise, available to make it easy to collect taxes fairly and efficiently in developing countries. In short, there is no way to improve tax administration except by improving it. The task can be made more manageable, however, by following some of the precepts set out below.

II. WITHHOLDING AND CURRENT PAYMENT

In the first place, all countries that have relatively successful income taxes collect most of the tax through withholding or "third party" techniques that in effect charge a third party with the tasks of deducting the tax from some payment being made to the taxpayer and remitting the proceeds to the government. Such withholding may be of two types: provisional or final. Amounts that are provisionally withheld are, in effect, credited against a final end-year liability and are in principle subject to adjustment through supplementary payments, or refunds, as the case may be. In contrast, other withholding may be treated as the final payment with respect to certain income, with no provision for subsequent adjustments. Both types of withholding are found in all countries, but the scope and precise form in which they are applied differ widely, depending on the structure of the economy and the capability of the tax administration. In addition, in some circumstances tax withholding is supplemented by a "current payment" system for other forms of income. This section outlines briefly the major forms and uses of these systems of tax collection and comments on their suitability in the context of a developing country.

A. Wage withholding

Most income tax revenues in every country consist of taxes withheld on the wages and salaries paid to employees by such large, organized activities as public sector agencies and private corporations. In fact, one of the principal reasons the income tax is more difficult to apply in developing countries is precisely because such "modern sector" employment income normally constitutes a much smaller part of the potential tax base. Nevertheless, it is invariably with respect to such income that the income tax can and does function most effectively and fairly (at least within the group of employees). Among the most important aspects to be considered in setting up a wage withholding system are its scope and its accuracy.

The wage withholding system should be as broad as possible

In principle, it is clearly desirable that the coverage of the wage withholding system should be as broad as possible. The withholding of tax from public sector employees, for example, is not an instance of government's simply putting money in one pocket and taking it out the other. Instead, it is an essential ingredient of an effective and fair income tax in at least two ways: first, by providing the necessary basis on which to assess and tax the global income of public employees and, second, by removing an obvious rationale by which others can rationalize their own (extra-legal) non-payment of taxes. As in the case of state corporations paying corporate taxes, public employees paying income taxes constitute a valuable "role model" for others less easily reached by the power of the state. All public employees should thus be subject to wage withholding (unless their income is below the taxable level).

All employees of private sector corporations and other organizations (non-profit, etc.) should similarly be subject to the wage withholding system, subject to the limit of administrative practicality. All wages with respect to which contributions to social insurance funds (or similar payments) are made, for example, should be withheld for income tax purposes. One obvious exception might be for the small firms subject to the "estimated" tax system discussed below, since if their books are so unreliable for other purposes they cannot be trusted for withholding purposes either. In general, however, the scope of the wage withholding system should be as broad as can possibly be managed.

In the absence of careful institutional study, it is not possible to be so definitive with respect to the precise form of the withholding system that should be adopted in any particular country. An "ideal" system, for example, might appear to be one that would leave most employees, who have no significant outside income, with no tax to pay (or refund to receive) at the end of the year. In other words, the tax withheld would precisely equal the tax due. Such a cumulative withholding system has long existed in Britain under the name of P.A.Y.E. (pay-as-you-earn), but the expense of achieving this degree of

1. For further discussion of the appropriate treatment of earned income, see Oliver Oldman and Richard Bird, "The Transition to a Global Income Tax: A Comparative Analysis", *Bulletin for International Fiscal Documentation*, 31:10 (1977), pp. 440-41.

perfection makes it quite impractical for a developing country.[2]

Some features of the British pay-as-you-earn system are worth noting

Nevertheless, the avoidance of the refund problem (see below) makes some features of the British tax system that have facilitated the P.A.Y.E. system worth noting: In particular, the application of (in effect) a proportional income tax rate to the vast majority of taxpayers and the restriction of applicable deductions basically to exemptions for dependents would appear to be highly desirable features of a workable income tax in a developing country. Striving for undue refinement with respect to either the progressivity of the rate structure or the delineation of the tax base is likely to yield few, if any, benefits in increased equity and substantial administrative cost and complexity.

The non-cumulative withholding system used in the U.S. and a number of other countries shares with the P.A.Y.E. system the characteristic of being in principle provisional rather than definitive in character. Unlike P.A.Y.E., however, the U.S. system is also generally provisional in practice. Many additional payments and refunds are therefore required to reconcile the taxes withheld over the course of the year with the taxes finally determined to be due.

A non-cumulative system can work on either a self-assessment (as in the U.S.) or official assessment (as in Canada) basis (unlike P.A.Y.E., which can only really work on the latter basis). The difference between the two methods of assessment is more rhetorical than real, however, since in either case *some* information must be obtained from taxpayers and *some* action (to accept or modify this information) must be taken by the administration.

In a developing country, where most taxpayers do not keep reliable or accurate records (or, if they do, cannot be made to reveal them), any system will almost inevitably depend primarily on official action, or the lack of it. Given the scarcity of administrative resources, however, it is obviously highly desirable to induce taxpayers (or relevant third parties engaged in transactions with taxpayers) to do as much of the authorities' work as possible. One obvious way to do this (widely used in the U.S.) is to overwithhold on most taxpayers, thus forcing them to reveal information to the authorities in order to qualify for refunds. Although this policy is surprisingly popular in the U.S. – most taxpayers appear to regard it as a welcome form of "forced savings" – it would probably not work in most developing countries, owing in part to the weakness of the tax accounting system and the (partly consequent) slowness and unreliability of tax refunds.

2. For a useful discussion and comparison of assessment systems, see N.A. Barr, S.R. James, and A.R. Prest, *Self-Assessment for Income Tax* (London: Heinemann Educational Books, 1977); see also Alan P. Murray, "Withholding and Pay as You Earn: A Contrast in British and American Methods of Tax Collection", *British Tax Review,* May-June 1962, pp. 173-86.

3. Systems along these lines may be found, for example, in Bolivia and Indonesia.

Provisional withholding requires a reliable system of tax processing and accounting

Indeed, without a fairly reliable system of tax processing and accounting, *no* system of provisional withholding can work very well. Unless amounts withheld are properly and promptly credited to the correct taxpayer account, for example, the refund process can never be counted on to correct for overwithholding. Even if the withholding rate is kept deliberately low in order to reduce the need for refunds, the amounts withheld still have to be credited to the right account if there is to be any final adjustment in tax liability at the end of the year. Moreover, both taxpayer and administration need to be sure that this matching will take place if the withholding system is to constitute, as it should, a principal structural component of the assessment and collection process.

The key to good accounting in this sense is a reliable system of taxpayer identification numbers. Quite apart from the obvious importance of a unique identifying number in assessing tax in the first place, such a system is essential to the functioning of a withholding (and current payment) system. Only when each withholding (or other) payment is reliably and promptly credited to the correct account can a refund system be established, for example. Similarly, only when both administration and taxpayer are sure that all payments are accurately recorded will it really be possible to make use of such enforcement devices as requiring proof of tax compliance before issuing passports, business licences, etc. Indeed, a reliable tax accounting system based on unique taxpayer identifiers seems an essential prerequisite to any significant improvement in either tax assessment or tax collection.

An alternative approach to wage withholding is less administratively demanding – but also further away from the presumed ideal of a global income tax. In this approach, a prescribed tax is withheld from wages by employers, transmitted by them to the government, and treated by the latter as the final satisfaction of tax liability on those wages.[3] The tax withheld in this fashion may be a flat-rate levy (in which case it is simply a gross payroll tax) or, more usually, graduated in accordance with the wages received by particular employees. There may, or may not, be some allowance made for the number of dependents or other personal deductions though the fewer such base refinements there are the better the system will function.

The central point about this approach, as it is usually applied, however, is that there is no direct contact at all between the employees and the government. In effect, each employer acts like a mini-assessing authority, determining who pays what, subject to at most an aggregative review by the revenue authorities. Indeed, where such systems exist, experience suggests that in practice many provisions of the substantive tax law – concerning, for example, fringe benefits and allowances – tend to be ignored. For a system of definitive wage withholding of this sort to function satisfactorily from an administrative point of view, the tax base should probably be as close to gross money wages as possible, since any variations lead to the need for the sort of detailed official verification which it is the presumed purpose of this approach to avoid.

From a policy point of view, such definitive wage withholding is tolerable only when most taxpayers subjected to this regime receive no other significant income and moreover receive wage income from only one employer. To avoid substantial abuse of this system, at the very least detailed information returns should be required from each withholding agent (employer), showing the amounts withheld and the tax base (gross income less stated deductions) by the name, address, and identification number of the taxpayer. Once this information is obtained, however, it is not clear why anything except administrative capacity should prevent the conversion of this system into a provisional withholding system, with final adjustment, as described earlier.

An alternative approach might be to require employees to submit to the employer – perhaps for transmission to the authorities as attachments to the annual withholding summary, perhaps to be kept on file for possible audits – a very brief form containing identifying information, the basis for any deductions (e.g. number of dependents), and a statement to the effect that they have no other significant source of income. Those who cannot so state must file regular individual returns (and pay currently, as noted below). This alternative has the obvious disadvantage of increasing the paper flow, but it has the possible advantage of putting the onus for compliance more clearly on the taxpayer, while still leaving tax collection for the employer to deal with. In some developing countries, however, such conceptual benefits should, like many other "nice ideas", probably be forgone to avoid flooding the already overloaded tax administration with still more unprocessable paper.

Wage withholding is the mainstay of personal income taxation

On balance, wage withholding inevitably constitutes the mainstay of personal income taxation in any country. In developing countries, such a system should be able to function satisfactorily throughout the public sector and in large private sector firms (for example, any involved in social security systems). The easiest withholding system to run satisfactorily is one with a relatively simple rate structure (probably not too progressive) and, especially, as simple a base as possible in terms of personal deductions and allowances. For most taxpayers, the taxes withheld could probably be taken as their full tax liability, and they need have no direct contact with the revenue authorities. For such a system to function as part of a decent income tax, however, employees should be required to provide some basic "coding" data to employers, employers need to provide identifying information on all employees to the authorities, and the administration needs to have a reliable tax processing and accounting system.

B. Other withholding

Aside from wages and salaries, the other form of income for which the withholding technique definitely can and should be used is income from such "movable capital" as interest, dividends, and royalties. The basic questions are similar to those already discussed with respect to wages, though the answers need not be the same.

It is much more common, for example, for withholding to constitute a definitive settlement of tax liability in the case of movable capital. The rationale for this approach is obvious in the case of non-residents, but it is far from obvious why the same is so often true in the case of residents – or why, indeed, there is so often *no* withholding on such payments domestically.[4] The usual arguments for such favouritism – in terms of "incentives" of various sorts – cannot be discussed here, but what can be said is that the failure to withhold any tax on payments of interest, dividends, and royalties from corporations (or governments) to individuals greatly weakens the administrative underpinnings of the income tax.

All payments for the use of movable capital should be subject to withholding

In principle, *all* payments from corporations to individuals for the use of movable capital – whether labelled "interest", "dividends", or "royalties" – should be subjected to withholding, preferably at a significant uniform rate.[5] (The rate applied to payments to non-residents is often constrained by treaties, but this point is not further discussed here.)

The recipients of most such payments are relatively well off but, as before, a good system of tax accounting and taxpayer identification numbers is of course essential if payments withheld in this way are to be credited accurately against final liabilities. In the absence of this infrastructure, such withholding would become in practice the final tax payment, with the probable result that the rates applied would be lower – although in principle there is no reason for this, since those from whom income is withheld can always file a full return if they are overwithheld. Without at least some withholding on income from movable capital, however, such income is all too likely to escape tax entirely in the circumstances of most developing countries, thus reducing the income tax in effect to a discriminatory tax on certain wages – at best perhaps supplemented by a "lump sum" tax on the self-employed (see below).

Two essential components of an effective income tax collection system are thus withholding on wages and salaries and withholding on interest, dividend, and royalty payments. In both cases, the ideal system would treat the tax withheld as a provisional payment of the final global tax liability, but in practice even a system that regarded withholding and the final payment as synonymous would, at least with regard to non-wage income, likely constitute an improvement in the circumstances of many countries.

4. The United States, for example, after 70 years of experience with the income tax is only now apparently ready to start withholding on interest.
5. For a rather similar recommendation, see Oldman and Bird, p. 442.

Other payments can be subjected to withholding as well

Much the same can perhaps be said with respect to a third possible form of tax withholding, namely on payments by government or large private corporations – for example, those that are designated as withholding agencies for other purposes – to individuals in forms other than wages, interest, dividends, or royalties. Examples are payments for rent, to independent contractors, or for the services of independent professionals. Withholding on such payments would obviously have to be on a gross basis and probably at a fairly low rate. In the absence of a decent taxpayer identification system and reliable tax accounting, a withholding system of this sort would in effect amount to a sort of discriminatory sales (or purchase) tax. With the right infrastructure in place, however, so that the amount withheld could be attributed to the right taxpayers and credited against their tax liabilities, this approach might provide a useful stimulus to some members of the "hard-to-tax" groups to comply with their legal obligations.

The feasibility and usefulness of this approach as part of an *income* tax system thus appears to depend upon the existence of a workable administrative structure: it cannot really be a substitute for the absence of this structure. In general, attractive as withholding of this sort may appear, it is generally hard to utilize as part of an income tax system in the context of most developing countries, though it may provide a support to such a system when coupled with the "estimation" system discussed later. Its usefulness in this respect, however, really depends upon the withholding rates being high enough to force taxpayers off the estimated system – a result which is again unlikely, in the absence of a decent administrative structure in the first place.

A final comment to be made about *any* form of withholding is that considerable care must be exercised in order to ensure that the amounts withheld by third parties on behalf of the government are in fact transmitted to the government as promptly as possible. For this purpose, a special withholding enforcement section is probably needed in the administration, particularly strong financial penalties should be imposed on non-compliers (who, in effect, are misusing public funds), and compliance should be made as easy as possible, for instance, by providing in a timely fashion any needed forms and information, by simplifying the relevant tax law (sometimes drastically), and by making it simple to transfer funds to official accounts.

C. Current payments

Even if withholding is used as extensively as possible, many self-employed persons will generally escape the system on much or all of their income: they will thus be advantaged relative to wage-earners. For this reason, if equity is a concern – as it presumably is in any country implementing an income tax – it is obviously highly desirable to introduce a system of "current payment" for taxpayers not subject to withholding (and consequently current payment) on most of their income. Taxpayers with certain characteristics – for example, with substantial non-wage income – may, for example, be required to make several payments, often quarterly, each year of the taxes estimated to be due that year.

Persons not subject to withholding should come under a system of "current payments"

Obviously, one problem with this system is to identify those taxpayers who should be filing on a current basis: this point is discussed further below. Another problem is to determine the basis on which the current payments should be made: as a general rule, the previous year's taxes are accepted, although it has often been proposed that such payments should be adjusted to reflect subsequent price increases.[6] Since one of the principal advantages of not filing currently is the inflation-induced reduction in real tax liabilities, this last point is a significant one in many countries.

Apart from the inflation problem, current payment systems need to have some "hardship" provision, in case this year's income falls well below last year's owing to some general or local disorder. This problem is usually handled by permitting amendment at the option of the taxpayer (and approval by the administration) subject to some substantial financial penalty if it turns out the revised estimated basis is too far (say, 10%) below the original base. A similar system might be used to induce taxpayers to *raise* their estimated base above that of the previous year (even if inflation-adjusted), but in this case a greater margin for legitimate error (say, 25%) would likely have to be allowed to make such a penalty politically tolerable.

Whatever the precise structure of a current payment system, it is clear that it, like provisional withholding, requires prompt and accurate taxpayer identification and tax accounting if it is to function satisfactorily. Once again, improvements in the income tax really depend on improvements in the tax administration that may not be easy to bring about. Nevertheless, despite its problems, some form of current tax payment, particularly for the self-employed, seems both a desirable feature of the income tax and perhaps a necessary accompaniment to increased use of withholding on other forms of income.

A "current payment" system can be introduced gradually

Where a current payment system does not now exist, it should probably be introduced gradually, over (say) a 5-year transition period. Corporations and taxpayers with business income (or substantial non-employment income) might, for example, be required in the first year (year 1) of the system to pay the tax due for the prior year

6. For one suggestion along these lines, see Richard M. Bird, *Taxation and Development: Lessons from Colombian Experience* (Cambridge, Mass.: Harvard University Press, 1970), p. 62. Useful discussion of current payment systems may be found in Patrick L. Kelley and Oliver Oldman, *Readings on Income Tax Administration* (Mineola, N.Y.: Foundation Press, 1973), pp. 343-88.

(year 0) plus 20% of the tax estimated for year 1 (e.g. year 0 tax times an inflation adjustment). Then in year 2, they would pay the balance due on year 1 (final assessment less amount currently paid on year 1) plus 40% of the tax estimated for year 2 (inflation adjusted final assessment for year 1). By year 5, all taxpayers would be on a full current payment system. The transitory revenue gain accruing to the state over this period might perhaps be considered belated recompense for the previous advantages received by these taxpayers. Apart from corporations, however, where this acceleration factor might be significant, the primary rationale for a current payment system is clearly equity (fairness of treatment of withheld and non-withheld taxpayers) and political considerations (improved acceptability of system by employees), not revenue.

A proportional income tax simplifies tax assessment and collection

As a final comment on this whole section, it should perhaps be emphasized how very much simplified tax assessment and collection would be if the income tax was linear in form, that is, consisted of a proportional rate tax with any desired progressivity introduced by relatively simple personal exemptions or deductions. With such a simplified tax structure, *all* payments from governments or corporations to individuals could probably be withheld at the flat rate without serious injustice being done. In the case of employees, they could file simple forms with their employers claiming the exemptions to which they were entitled, as described above. The employers would then apply the flat rate to the wages net of deductions, thus yielding a tax with the desired progressivity across employees (at least those who work at only one job). Others would of course have to file tax returns to claim any refunds to which they were entitled; this procedure might put a strain on the tax accounting process but it would, at the very least, bring more taxpayers into the system and, one might hope, also provide some revenues with which to improve the process.

There is no way to avoid some rough edges even in a simplified system: but the "rough justice" that could be attained by an effectively collected, albeit relatively proportional and simple, income tax is likely to prove more equitable in practice than the results of a more refined tax structure that cannot be comprehensively and fairly applied. Whether administration is viewed as a constraint on the design of tax structure or the design of tax structure is viewed as a factor affecting administration, the result is the same. A simple, not too progressive, not too ambitious tax seems the best that can be achieved in most developing countries. Attempts to go beyond this are likely to produce anomalous results – for example, with greater nominal progressivity inducing still greater evasion and consequently less progressive outcomes.

III. TAXATION OF ESTIMATED INCOME

The same sort of pragmatic striving for "rough justice" – the attainable "good" as opposed to the unattainable "perfect" – underlies the second major topic to be discussed in this paper, namely, the taxation of "estimated" or "presumed" income. As mentioned earlier, *all* countries encounter a great deal of trouble in taxing the self-employed in business, agriculture, and the professions. Several techniques – all very much of the "rough justice" variety – have been developed in various countries to cope with this "hard-to-tax" group.

The techniques used for this purpose are rather similar around the world, although they tend to be used somewhat differently in developed than in developing countries. The common element everywhere is the estimation of taxable income on some basis that is more readily verifiable by the tax authorities than is the taxpayer's own declaration of income. The factors used for this purpose range from information on sales and wealth to external indicia of earning power (e.g. number of employees) or consumption (e.g. ownership of houses and cars). More developed countries tend to rely more on such accounts-based methods as the "net worth" method of estimating income (as the difference in wealth at the beginning and end of a tax period plus consumption during the period).[7] Developing countries, where taxpayers seldom leave as many potentially traceable financial tracks, necessarily rely more on "objective" external indicia. But both groups of countries use both methods to some extent in accordance with their feasibility and the necessity to get the job done. The principal difference between developed and developing countries is that in the latter it is more common to use such estimating methods as a method for *final* determination of income rather than as a technique for reviewing the income declared by those taxpayers selected for audit, as is commonly done in countries where more reliance can be put on accounting records.

The Musgrave Mission

Undoubtedly the best-known and most developed system of taxing estimated income is that developed in Israel (the *takshiv*).[8] For present purposes, however, a variant recently proposed for Bolivia by the Musgrave Mission is especially interesting.[9] Under this proposal, taxpayers were to be divided into four groups: (1) very small taxpayers, (2) small taxpayers, (3) other "hard-to-tax" groups, and (4) others. The first group were to be exempted, in line with normal income tax principles on exempting minimum incomes, and the fourth group would be required to keep adequate books and records and sub-

7. The net worth method is discussed in United Nations Department of Social and Economic Affairs, *Manual of Income Tax Administration* (New York, 1967).

8. The Israeli system is discussed in Arye Lapidoth, *The Use of Estimation for the Assessment of Taxable Business Income* (Amsterdam: International Bureau of Fiscal Documentation, 1977).

9. Richard A. Musgrave, *Fiscal Reform in Bolivia* (Cambridge, Mass.: Harvard Law School International Tax Program, 1981), chap. 17.

jected to the regular income tax (including selective audit procedures, using techniques such as those mentioned above to encourage compliance and punish fraud). This fourth group, for example, might include foreign enterprises, state enterprises, and corporations benefiting from state grants or fiscal incentives.

The second group distinguished, the "small taxpayers", were to be subjected to a special tax in lieu of the personal and corporate income taxes *and* the sales tax that would otherwise be applied (at least in principle). "Small taxpayers" were defined as those with not more than two employees and were to be distinguished from the exempt group and the other groups mentioned above on the basis of gross sales. In turn, the gross sales figures were to be determined in part by a "short return" to be filed by such taxpayers, supported by a minimal set of books that taxpayers were to be required to keep. Since for obvious reasons no reliance could be put on this information, however, rough physical indicators (see below) would also be used to estimate gross sales and hence classify taxpayers. (The rationale for requiring some form of books and taxpayer filing was presumably largely to accustom taxpayers to the annual tax routine and to keep them aware of their fiscal obligations.)

Once taxpayers were classified by type of activity and gross sales, all those in a particular group would be subjected to a flat lump-sum tax, set at approximately the amount that would result if the regular income and sales tax rates were applied to the estimated average income of the group. The exempt level, and the level at which taxpayers are supposed to move to the regular system, varied widely from category to category, depending upon the presumed relation between estimated gross sales and taxable income (and sales).

Lump-sum minimum tax

The system described in the preceding two paragraphs is of course not really an income tax at all. Rather, it is a lump-sum minimum tax intended to be levied on a large group of small businessmen, artisans, and traders in lieu of other accounts-based taxes on income and sales. It is closer to a set of business license fees than to an income tax since the principal factors determining who pays, and how much they pay, are (a) the nature of the activity and (b) whatever "objective" indicators (e.g. number of employees) are used to estimate gross sales. Such a tax may serve a most useful purpose by incorporating more taxpayers in the tax net at minimum administrative cost. The taxes levied should, at the very least, of course be sufficiently high to more than compensate for the cost of establishing and running the system. Its incidence and economic effects are in no sense likely to be those of an income tax, but this is not a very relevant criticism since the option of levying an income tax is by definition not available. Either a simple tax such as this is levied on these small taxpayers, or they are not likely to be effectively taxed at all, at least not directly. This seems sufficient rationale for considering a system along these lines in most developing countries.

Disadvantages of the system

The principal problems with this system are twofold. On the one hand, because it is so crude, in all likelihood the taxes charged will have to be set on the low side to reduce the level of tax protest as well as the possibility of imposing undue hardship in particular instances. But if the taxes levied through this means are low, not only will there be no incentive to move to the regular income tax system, but there will also be substantial incentive for larger firms to disguise themselves as "small" (in terms of the indicia used to decide size, such as number of employees) in order to keep the benefits of the fixed-tax system.

On the other hand, if the categorization system is upgraded along the lines discussed below, the costs of administering the system with respect to truly small taxpayers will probably soon exceed the revenues produced. There is no way to avoid such difficulties except by constantly improving tax administration in general to try to confine the use of the presumptive system to the group for which it is intended. Again, however, it must be recalled that reaching small traders and artisans through direct taxes in the context of a developing country is likely going to be done either this way, or not at all. In the circumstances, it seems worth developing a system along these lines in most developing countries: the alternative is to do nothing, either explicitly (for example, by setting exemption levels high) or, much worse – and much more common – implicitly, by simply not enforcing the law which purports to subject these people to income tax, thus increasing the general perception of this potentially fairest of all taxes as "unfair" by those, mostly employees, who cannot escape paying it.

The "hard-to-tax" group

The third group distinguished in the Bolivia report was taxpayers who are not "small". These taxpayers were to be subjected in principle to the regular income tax, but because they were, for some reason, considered "hard-to-tax", the regular administrative procedure (of verifying books and records by selective audit) could not readily be applied. This important group of taxpayers in most developing countries includes, for instance, the professions and all but the largest businesses. In practice, faced with the difficulty of verifying information supplied by such taxpayers, tax officials generally use either very arbitrary methods of assessment or, perhaps most commonly, bargain with taxpayers as to the amount of tax to be assessed (often within the limits set by the official's need to satisfy the revenue targets that he has been given). Such individual bargaining between officials and taxpayers completely undermines the rationale of the income tax and is obviously highly conducive to fraud and manipulation on all sides. On the other hand, it is usually impossible for overworked and undertrained officials to cope with recalcitrant taxpayers in a hostile environment in any other way. In these circumstances, the method of standard assessment used in Israel, Korea, and other countries, and recommended for Bolivia, seems to be the best possible solution, indeed perhaps the only one.

Standard assessment guidelines

The essence of this method is the establishment of a set of *standard assessment guidelines* for each major economic activity, on the basis of which the income for any individual taxpayer can be estimated in a relatively objective fashion. Guidelines may be developed for various activities by a relatively small group of experts, and updated from time to time in the same way, but they require very little expertise to apply. Basically, all the assessing officer has to do is to obtain information on a series of relatively objective indicators – the number of employees, their skill level, the nature and type of machinery installed, stock on hand (inventory), etc. – go to the relevant guide and calculate the tax on the basis of the ratios shown there between the indicators on which he has collected information and gross sales, and between gross sales and net income.

The ratios in the guides are in principle based on careful studies by the experts mentioned above of the particular trade, industry, or profession in question and are intended to represent typical or average rates.[10] As a rule, a different guide is needed for each trade or profession in each major city or region – which means that it would take many years, and much work, to obtain comprehensive coverage in this way. The realistic aim is therefore not to cover everything but rather to focus on those areas where public perceptions, and the knowledge of officials, suggests there are serious problems.

Several aspects of this approach should be underlined. In the first place, although a principal reason for moving to the estimated system is to reduce the scope for bargaining or negotiation about individual cases, trade organizations (*not* individual firms) should likely be closely consulted in the initial stages of developing the relevant guides both in order to obtain relevant information and also to persuade them that it is better that all their members pay a (roughly) fair tax than have taxes arbitrarily imposed upon them. (Imposition of the system must not, however, be conditional on the *agreement* of such organizations!) Among the information used to develop assessment guides may be available tax information (includes customs and excise) on firms with fairly good records, other information on sales and purchases, direct studies of firms, general industry studies, and so on.

Secondly, it is critically important that as many "indicators" as possible be used in determining the tax base in order to avoid the obvious distortion and evasion that could otherwise result. The development of these indicators and the related sales, expense, and income ratios is a difficult and complex task if it is done right, as it must be if this procedure is to be of any use. It will probably therefore take several months to develop a useful guide for any particular line of activity. This means the system should be introduced selectively, preferably concentrating initially on areas in which there is thought to be significant revenue potential and for which reasonable *quantitative* (not qualitative) information on indicators is available. As the small group of economists and accountants charged with developing these guides becomes more expert, they can begin to tackle more difficult areas, in addition to periodically revising previous guides (for example, to take account of price changes).

Thirdly, the tax established on the basis of the assessment guides should be a *minimum,* unless the taxpayer can show that his actual liability is *less* – which he can do only by meeting the detailed record-keeping requirements established by the revenue authorities (and subject, of course, to audit). Taxpayers should be permitted to claim losses, investment incentives, and similar concessions *only* if they file a detailed return supported by creditable, and verifiable, records maintained in a prescribed fashion (and externally audited). This provision is important to provide some incentive for taxpayers to move off this "minimum estimated tax" system and into the regular income tax system.[11] Ideally, the amounts estimated in the guides should be on the high side to encourage better record-keeping, but this may not prove politically feasible, so that some inducements (such as access to incentives) must undoubtedly be used to encourage the upgrading of accounts.

A final point to be considered is whether the standard assessment guides for particular activities, once prepared, should be *published* in some form. Two reasons in favor of publication are, first, to act as a check on possible corruption or misuse by officials and, second, since the income estimate based on the guide will be a presumptive minimum, perhaps to stimulate more accurate and complete taxpayer declarations. Since the ultimate aim is to move everyone onto the regular income tax system, this point is important in principle, though it may not amount to much in practice given the probable low level of the estimated taxes. The only argument against publication is that taxpayers may then get too much information on how to arrange their affairs to minimize tax. This argument can easily be overdone, however, since it will not be so easy to do this if a number of indicators are used, as should be the rule.

It should be noted also that the guide may also be used by officials as an initial starting point for the selective review of taxpayers who keep books in apparently satisfactory form. When the reported amounts differ widely from the averages set out in the guide, there is obviously something requiring further investigation.

On balance, the "guide" approach seems the *only* available way to deal with the "hard-to-tax" groups, whether in the professions, agriculture or business. The key to success appears to lie in being clear and open about what is being done and why, in the careful and complete study of the selected industry, and in allowing field officers as

10. There will very likely be wide variation around these averages, however: for one instructive example, see the detailed study of small retailers in Sierra Leone in Barry L. Isaac, "Price, Competition, and Profits among Hawkers and Shopkeepers in Pendembu, Sierra Leone: An Inventory Approach", *Economic Development and Cultural Change,* 29 (June 1981), pp. 353-74.

11. The successful use of this incentive in postwar Japan (the "Blue Return" system) is discussed in Kelley and Oldman, pp. 221-29.

little discretion as possible in applying these rules. Those who wish to rebut the presumed minimum income always have the option of keeping good books and filing regular returns. They should be encouraged to seize this option by restricting incentives, loss offsets, etc., to those who do so.

It would obviously also be good if the income presumed were, on the average, on the high side. As a rule, however, it is probably more likely to be on the low side both for reasons of political and administrative feasibility and to avoid the need to deal with numerous borderline "hardship" cases – a localized crop failure in agriculture, for example. The result of this bias is that, unless great care is exercised, this system, instead of fostering movement towards the regular system, will discourage such movement. To offset this "locking-in" of taxpayers to the (favourable) estimated system, the system should be reviewed periodically (preferably yearly) in accordance with price and other changes, so that at least matters do not get worse in this respect.

Taxes levied on the basis of standard assessment guides are in a sense not really "income" taxes, unless the estimated income is an exceptionally good measure of the (unknown) actual income. They are, in effect, taxes on the set of factors used to estimate income, with consequently different incidence and economic effects than a proper income tax. Nevertheless, the adoption of a standard assessment system as a basis for securing a minimal tax contribution from the "hard-to-tax" segment of the population would constitute a significant improvement in the fairness and efficiency of the overall tax system in most developing countries. This approach is not a panacea; nor is it particularly easy to implement successfully. But there is really no other way to go if the direct tax system is to be expanded to encompass all taxpayers above some minimal exempt income, as it should be.[12]

IV. FINAL COMMENTS

The establishment of a really effective income tax in a developing country in the end depends largely on the successful implementation of the two devices to which the bulk of this paper has been devoted – a withholding and current payment system on the one hand and some form of "estimated" taxation of the hard-to-tax groups on the other. In addition, however, there are a number of more conventional aspects of tax administration that are also extremely important in this regard. Without attempting in any way to be comprehensive – nothing is said here, for example, about the obvious need for good staff training and an appropriate organizational structure – this section is intended simply to call attention to a few other general points that are relevant to improving income tax administration in developing countries.[13]

It was noted earlier, for instance, that before one could assess and collect an income tax one must first identify the potential taxpayers. An obviously important element of improving the income tax in any country is therefore a program to bring non-filers into the system. It is important, however, not to put too much emphasis on this problem as compared to the problem of assessing and collecting taxes once potential taxpayers are on the rolls. The *number* of *potential* taxpayers is often huge. In all likelihood, however, most of them are not individually very important.

"Information overload"

Undue emphasis on adding new taxpayers to the rolls has, in many countries, resulted in a sort of "information overload", clogging up the administrative channels with masses of paper that in the end – in part perhaps because of an inappropriately low rate and exemption structure – hardly produces enough revenue to cover the cost of processing it. Too much stress on expanding the tax rolls may thus result in the addition of a large number of small taxpayers, but only at the cost of substantial diversion of administrative efforts from the more difficult and – in either revenue or equity terms – more important tasks of assessing and collecting tax from the much smaller group evading significant amounts of tax, most of whom are probably already nominally in the system. Efforts to enrol new taxpayers should therefore always be focused on areas where there is reason to believe there are significant net revenues to be gained – and should be matched by efforts to clear the existing rolls of duplications and errors.

The principal methods usually suggested for expanding the tax roll are field censuses and numerical identification systems. There is little to be said for the first of these techniques. The use of revenue officials to carry out door-to-door canvasses in selected districts looking for potential taxpayers is usually a waste of time and scarce resources. This is particularly true when, as has often proved to be the case in countries employing this technique, the basic assessment-collection system – already weak – is weakened further by this diversion of resources and thus rendered even more incapable of making effective use of any information gathered.

Unique taxpayer numbers

The introduction of a system of unique taxpayer numbers has much more to be said for it – indeed, it is probably an essential part of an effective income tax – but it too is not without its dangers. In the first place, it must again be remembered that enumerating taxpayers is in no sense a substitute for taxing them. The best identification system in the world will not produce revenue if no one is out there assessing and collecting tax, so it is important not to concentrate too many scarce resources on identifying non-filers in the belief that this exercise alone will be productive in revenue terms.

Secondly, if – as should be the case – the identification system is to be used in part as an enforcement mechanism

12. Bird, *Taxation and Development*, pp. 87-102, contains an earlier discussion of presumptive techniques which is generally less favourable to their use outside of agriculture. Another decade of experience has, however, convinced me that there are really no alternatives.

13. For useful general references see Kelley and Oldman and the United Nations *Manual* cited earlier.

– for example, by requiring "tax clearance certificates" before issuing passports, business licences, and other official documents – this can only be done if taxpayer accounts are well-maintained and up-to-date. (The necessity for this was also mentioned earlier in connection with withholding.) Indeed, perhaps the main usefulness of a computerized system of taxpayer identification numbers may be to establish a reliable system of current taxpayer accounts. Once such accounts are created and kept up-to-date, information on the state of these accounts can indeed be used to exert pressure on taxpayers to comply through the device of clearance certificates. In the absence of reliable internal records, however, heavy recourse to this device has usually generated still more bureaucratic delays and opportunities for corruption and fraud (e.g. the industry of producing false tax certificates that flourishes in some countries) and produced little, if any, net administration gain.

Centralization

A final potential problem with a mass taxpayer identification program is the potential it holds for undue centralization, particularly if heavy emphasis is to be placed on its computerization. It is clear that a modern income tax requires unique taxpayer identifiers, that such numbers must be issued centrally, and that maintaining taxpayer accounts centrally by computer is not only highly desirable but probably, given the number of taxpayers, administratively essential in large developing countries. Nevertheless, the impetus the introduction of such a system gives to centralization must be weighed carefully against these advantages, particularly in larger and more regionally diverse countries. The basic advantage of a centralized administrative system is clearly the greater opportunity for control it gives to the central administration. But this can also be a serious disadvantage.

Local tax officials

In the most fundamental terms, the essential problem facing the tax administration in a developing country is its lack of information. Much of the information needed to administer taxes fairly and effectively can *only* be obtained locally. Indeed, it could be argued that there is no functioning income tax system anywhere that does not, in the end, rest on the knowledge and experience of local tax officials. Such officials, invariably underpaid and often unrespected by their superiors, are the weak point of tax administration in most developing countries. It is therefore not surprising that administrative reformers often try to bypass local administrations and to reduce the discretion open to them by centralizing operations in various ways. (To some extent, indeed, this path was suggested earlier with respect to the estimated tax system – though it will be recalled that the need for developing special regional and local guides was stressed.)

Some centralization is obviously needed, as noted above, but in principle the purpose of collecting information centrally should be to *support* the effective decentralized administration of the tax system, not to *supplant* it. There is nothing more important in improving tax administration in most countries than strengthening local tax offices, and the efforts of reformers should be aimed at utilizing local knowledge and improving coordination (and trust) between local, regional, and central administrations. As is so often the case with administrative matters, no short cuts seem available to bypas this time-consuming and difficult task and attempts to do so may make things worse.

The legal structure of the income tax in a developing country should obviously be designed to permit and support its effective implementation. This aim may be facilitated, for instance, if the rate structure is not excessively progressive – indeed, if it is relatively uniform over a fairly wide range of taxpayers. The rates should, however, be high enough at the lower end to ensure that revenue from those included in the tax net at least cover the cost of processing the associated paper. On the other hand, since a truly mass income tax is not a feasible goal, the tax should not encompass the bulk of population (that is, it should have an exemption level above the average income level). Similarly, the law should provide for an effective withholding and current payment system and for a system of presumptive taxation along the lines discussed earlier.

Penalties, appeals and general administrative procedure

In addition, the law should provide an adequate penalty structure, appeals system, and general administrative procedures. The appeals structure, for example, should be as simple as possible to provide some escape from injustice without providing an easy means of tax avoidance (through, for example, unpenalized deferral) for the well-to-do. The penalty structure should be primarily (perhaps exclusively) financial in character and probably progressively related to the amount of tax evaded and the seriousness of the offence.[14] Non-complying withholding agents, for example, should be subject to more severe penalties since they are in effect stealing the funds of others. There should also be adequate provisions for real interest payments on delayed taxes (or refunds). All these matters obviously require a careful and systematic examination in the context of each particular country, but the general rules set out above will probably hold in all cases.

Audit and collection functions

Much the same can be said of the obvious need to improve the audit and collection functions in almost every

14. A particularly useful discussion of penalty structures may be found in Oliver Oldman, "Controlling Income Tax Evasion", in Joint Tax Program, *Problems of Tax Administration in Latin America* (Baltimore: Johns Hopkins Press, 1965), pp. 316-43.

developing country. The relevant general rules in these cases may perhaps be summed up briefly as follows. Audits, to be effective, must be selectively based on some rational criteria, and should include intensive field audits conducted by well-trained officials. Anything less – the usual "office audits" amounting to little more than numerical verification and/or arbitrary adjustments, for example – usually does little more than delay the collection process and jam up the appeal mechanism.

Much more effort should also be devoted to the collection of assessed taxes than is usually done. All too often collection agencies in developing countries are little more than "tellering" agencies, waiting for taxpayers to come in and pay up.[15] Effective collection is also really a field task, requiring intensive efforts to reduce arrears in a number of obvious (usually painful) ways that are spelled out in all manuals on tax administration. In the case of both audit and collection, considerable thought should also be given to the development and implementation of quantitative criteria for appraising the degree of success achieved by different district offices. This is one sort of "targetting" that seems to be inadequately utilized in most countries.

V. CONCLUSION

Two underlying themes run throughout the varied subjects discussed in this paper. The first such theme is that improving income tax administration is an essential part of income tax reform in any country: without administrative improvement, it is simply not possible to have a meaningful direct tax system. To say this is no doubt to repeat a cliché: but it is also a fact, and one that must be kept constantly in mind in considering the real merits of the varied and ingenious policy ideas that are inevitably suggested in the course of a major tax reform effort.

The second theme, perhaps less obvious to those who have not gone through the exercise in detail, is that the administrative constraint requires that the tax be kept as *simple* as possible in structure if it is to be implemented effectively. Moreover, the highest aim that can realistically be achieved is likely to secure at best a degree of "rough justice" in the allocation of the cost of government among taxpayers. Most fancy schemes to improve tax administration, for example, collapse of their own weight – by creating information overload (elaborate "cross-checking" schemes), by overcentralizing (rigid "master tax roll" schemes), or by postulating miracles (the instantaneous creation of a well-paid, well-trained group of "incorruptible" officials).

The real lesson running through much of this paper is that reformers, whether concerned with "policy" or "administration" (what is the former without the latter?), should as a rule be very *risk averse.*[16] That is, recommended changes should be considered very carefully to ensure that their full (or, more commonly partial) introduction will not damage revenue yields severely or produce unexpected (and undesired) inequities. There are too many instances, for example, of "all-or-nothing" computerization messing up a functioning revenue system to be comfortable about proposals that rely heavily on the merits of the magic machine. Tax reformers, like peasants whose survival depends upon their ability to wrest a minimal amount of sustenance from an uncertain environment, should introduce change with caution, incrementally, and experimentally, in order to avoid the fate of those who tackle the unknown with undue hubris.

This counsel of caution does not mean nothing can be done, and even less that nothing should be done. But it does mean that not much can usually be done quickly and that considerable thought and effort have to be devoted to institutionalizing and implementing even the most desirable reforms before serious – and in the worst cases, irreversible – mistakes are made. An essential element of a meaningful income tax reform is thus a careful, detailed, and realistic study of the limits and potentials of the administrative system that is expected to implement any desired reforms.

Finally, in the context of most developing countries, it has been suggested here that two key administrative aspects that seldom receive the attention they deserve are the effective use of estimated assessments on the one hand, and withholding on the other. Neither is as easy to do well as one might at first think, but without substantial efforts in both areas, it is probably impossible to impose successfully even a roughly effective and fair direct tax in a developing country. It is therefore suggested that much more attention should be focused on improving administrative capability in these two respects than has usually been done, if necessary even at the expense of such other worthwhile efforts as sweeping more taxpayers into the (leaky) tax net.

15. This characterization is taken from an important and stimulating study of tax administration by Alex Radian, *Resource Mobilization in Poor Countries* (New Brunswick, N.J.: Transaction Books, 1980), chap. 6.

16. I would now add this characteristic to the "rules for would-be reformers" set out some years ago in my "Tax Reform and Tax Design in Developing Countries", *Rivista di scienze finanziario e diritto fiscal,* 36:2 (1977), pp. 297-306.

Pakistan's Budget for Fiscal Year 1982/83*

by Ahmad Khan**

While unfolding the economic policy package for Fiscal Year 1981/82, the Finance Minister had informed the Nation of the liberal tax policy measures the government intended to pursue with a view to making the tax system responsive to growth in the national economy. The policy package emphasized the increased participation of private sector investment in the national economy, stricter financial management in the case of public sector corporations for improving their efficiency, raising production both in the industrial and agricultural sectors of the economy, and correcting the balance of payments position. The various measures adopted through the Finance Ordinance, 1981, included tax exemption of income from various investment schemes, an increased rate for the initial depreciation allowance with respect to plant and machinery, a 5-year tax holiday for companies engaged in the exploration for and extraction of selected minerals, recouping of the depreciation allowance in the case of plant and machinery used by oil exploration companies only to the extent of initial depreciation, reduction of the corporate surcharge from 10% to 5%, admissibility of 1⅓ times the actual expenditure on advertisement in the case of taxpayers engaged in the export of carpets and engineering goods, etc. The concessions in direct taxes were supplemented by adequate fiscal measures in the area of customs duty, sales tax and central excise.

The Pakistan Economic Survey 1981/82 reflects the positive effects of the various fiscal measures adopted through the Pakistan Budget for Fiscal Year 1981/82. The growth in gross domestic product (GDP) for Fiscal Year 1981/82 has been estimated at 6.6%, surpassing the target and marking a continuation of the process of economic revival and financial discipline that has characterised economic policy since 1977. All sectors of the economy contributed significantly to this rising trend of GDP. Agriculture, accounting for 30% of GDP, has grown by 4%, close to the preceding year's level. The commodity producing sector outpaced the services sector. Manufacturing production, which rose by 12.1% and its large scale component by 14%, not only excelled last year's growth but also the plan target for the year. There has been substantial expansion in the production of a large number of industrial items. Sugar output showed a record increase of 4.1%. The production of chemical fertilizer and cement also recorded a sharp increase, thereby easing the balance of payments situation. The growth trend in industrial production indicates a positive response from the private sector to the congenial climate provided by the Government for industrial progress. The industrial sanctions issued between July 1977 and March 1982 rose to 37 billion Rs. as against 9.4 billion Rs. during FY 1972 through FY 1977.[1]

The new policy of prudent financial management and decentralization has yielded fruitful results in the public sector industries where production rose by 13% and sales by 17%, thus showing a rise of 41.32% in pre-tax profits during the current fiscal year over profits realised in the preceding fiscal year. These corporations also showed a rise of 13.43% in production during the current fiscal year as against the last fiscal year on the basis of the production index at constant prices of Fiscal Year 1977/78. Total employment in public sector corporations increased to 80,588 as against 76,843 during Fiscal Year 1980/81.

The international trade and balance of payments situation was severely affected by the deepening world recession, a crash in the demand for and the price of cotton, appreciation in the value of the U.S. dollar and a slowdown in the inflow of home remittances. Exports of manufactures were adversely affected by the link of the Pakistani rupee with the appreciating dollar in the first half of the financial year, resulting in a halt in the recent growth trend of about 26% per annum in export earnings. The cumulative result was an adverse effect on the overall balance of payments position.

Within the past few years, the Government has launched an ambitious program for developing the engineering goods industry and progressive local manufacture for imported components in the case of motorcycles, refrigerators, air-conditioners and tractors. The result is that Pakistan is now on the threshhold of developing an engineering goods industry, most of which will be set up in the private sector. A National Engineering Manufactures and Export Council has been set up to look after the growth of engineering industries.

The overall economic situation reflected through the Economic Survey 1981/82, however, shows that, notwithstanding the sustained economic recovery during the last 5 years, structural weaknesses still persist, and efficiency and productivity are still low. The savings rate remains poor with a wide gap between investment and savings and in the external balance of payments. This has necessitated a dependence on foreign debit which is continuously rising.

The development trends during the current fiscal year, thus, serve as a prelude to the fiscal policy measures adopted through the Budget for Fiscal Year 1982/83 and are an indicator of the legislative intentions behind introducing the various measures. The Finance Minister in his budget speech of 16 June 1982 announced that for meeting the revenue gap of 4,923,000 Rs. it has been the Gov-

* The Finance Minister announced the Budget for Fiscal Year 1982/83 on 16 June 1982. Simultaneously, the Finance Ordinance, 1982, containing the provisions of the fiscal measures announced in the Budget speech was enacted. The Ordinance immediately became effective in so far as the provisions relating to indirect taxes were concerned. The provisions relating to direct taxes became effective from 1 July 1982, except where otherwise provided.

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1. These sanctions relate to permissions to set up new industries as issued by the Controller of Capital Issues, Ministry of Finance.

ernment's objective to protect and enlarge the incentives for savings and investment, to restrain inessential consumption, to encourage exports and to economise on imports, and to provide some relief to the fixed income groups in the public sector and poorer sections in society. The policy objectives are, thus, intended to continue and consolidate the existing pace of overall economic development through continuation of the existing fiscal incentives as supplemented by additional concessions. Simultaneously, Pakistan continued the process of Islamization of the economic system, which it is fully committed to expand over time in such a way that all other contradictory and parallel processes die out and the general welfare of the people is enhanced.

With the above objectives in view, the Budget for Fiscal Year 1982/83, as a starting point, embarked upon introducting the necessary structural changes in the concepts of the various corporate laws and the monetary and banking policies of the loan-giving financial institutions and banks. These changes have kept in view the financial needs of the private sector as well as the bottle necks in a smooth administrative set up of the industrial establishment. The measures to protect domestic manufacturing industries and continuation of the existing tax concessions also form part of the overall economic policy package. The Budget announced the various steps in consolidating the process of Islamization. The salient features of the economic policy for Fiscal Year 1982/83 are dilated below.

A. ISLAMIZATION OF THE ECONOMIC SYSTEM

Additional measures to be taken during Fiscal Year 1982/83 with the ultimate objective of an Islamic economic system in Pakistan include:

(1) A comprehensive program of "Doawa"[2] will be developed for which a sum of 10 million Rs. has been allocated in the budget to support this program.

(2) In order to further promote the scheme of "Qarz-e-Hasna" (interest-free loan), so far operated by the nationalized banks, a sum of 5 million Rs. has been contributed to the Qarz-e-Hasna Fund. This will increase the total sixe of the Fund to 15 million Rs.

(3) With effect from "Rabi" 1982/83, provisions pertaining to the compulsory levy and recovery of Ushr (i.e. religious levy on agriculture produce) under the Zakat and Ushr Ordinance, 1980 have been enforced.

(4) After the success of the non-interest instrument (Participation Term Certificates) introduced during Fiscal Year 1981/82 for providing medium term finance to industry replacing the system of interest-free instruments, it has been extended to meet the working capital and fixed investment needs of trade and industry also on a non-interest basis. The new instruments to be introduced from Fiscal Year 1982/83 include "Musharika" and "Leasing and Hire-Purchase". The technique of "Musharika" denotes a temporary partnership in which both the customers and the bank contribute financially on a profit-loss sharing basis. The customer will operate and manage the venture while the bank will evaluate and monitor the performance. "Leasing and Hire-Purchase" will meet the fixed investment needs of industry for a predetermined fixed period, and supplement the existing concept of equity participation by banks and financial institutions. These schemes are essentially project-oriented where the banks will carefully evaluate and analyse the projects and finance them on the basis of cash-flow analysis, managerial ability and reputation for business rectitude rather than balance sheet considerations.

(5) In the light of the satisfactory results of the Small Business Finance Corporation (which functions on a non-interest basis) in provinding finance to small industrial undertakings, its scope has been extended by increasing the loan limit from 150,000 Rs. to 500,000 Rs. and the criterion for eligibility in terms of total assets from 500,000 Rs. to 1,500,000 Rs.

B. MEASURES FOR STIMULATING PRIVATE INVESTMENT

Budgetary measures to increase the pace of development in the country, particularly for stimulating private initiatives, include the de-regulation and the relaxation and liberalisation of certain provisions of the existing corporate laws. These are:

(1) At present, the provisions for registration of the Monopolies and Restrictive Trade Practices (Control Prevention) Ordinance, 1970, are attracted when the value of the assets of a private undertaking reaches 30 million Rs. This limit has been raised to 50 million Rs.

(2) Under the Capital Issues (Continuance of Control) Act, 1947, and the rules framed thereunder, a private company must be converted into a public limited company if the issued capital exceeds 5 million Rs. This ceiling has been raised to 10 million Rs.

(3) The present practice of approval of the remuneration of sponsor-directors and their relatives by the Controller of Capital Issues has been dispensed with, except where a company incurs a loss for a continuous period of 3 years or its directors derive remuneration and benefits disproportionate to the profits shares with outside shareholders. In such cases the Controller of Capital Issues will continue to have the right to fix the remunerations of the sponsor-directors and their relatives for a specified (but extendable) period of time.

(4) In a large number of industrial projects, the financial institutions have acquired the right to nominate directors to the Boards. Keeping in view the fact that it is not always possible for all financial agencies to have competent representatives on all the Boards and that it is not desirable to get the financial institutions involved in the day-to-day management process of the industrial projects, it has been decided that in the case of Government-sponsored or owned financial institutions and banks:
- the loan-giving agencies will coordinate their

2. This connotes preaching of Islamic thought.

representation policy and collectively nominate one director representing them to the Board of a borrowing company;
- similarly, when financial institutions and banks hold equity in a company, they will ordinarily nominate one director jointly to the Board. However, if the exposure of the financial institutions is too large or the company does not maintain a record of satisfactory performance, the institutions will be free to exercise their right to proportionate representation on the Board.

(5) The present system of allowing financial institutions the right to convert a percentage of their loan into equity does not, in certain situations, operate equitably between the equity holders and the lending agencies. It has, accordingly, been decided that:
- in respect of the companies, the loan conversion option will be exercised in such a manner that the options exercised by all the financial institutions together do not exceed 25% of the paid-up capital;
- in the case of sale of shares by the financial institutions, the right of first refusal will be given to the equity holders. This will not apply to the sale of shares held by one financial institution to another.

The relaxations regarding nomination of directors and conversion of loan into equity will not apply, for the time being, to Participation Term Certificates (PTCs).

(6) Under the existing system, no permission from any Government agency was required for establishing industrial units involving an investment of 20 million Rs. with a foreign exchange equivalent of not more than 10 million Rs. These limits have been enhanced to 30 million Rs. with a foreign exchange component of 15 million Rs.

C. FISCAL MEASURES

The fiscal measures adopted through the Budget for Fiscal Year 1982/83 essentially aim at continuation and addition to the existing liberal income tax tax concessions, an overall nominal increase in customs duties on certain items to protect domestic industry, concessions in excise duties and sales tax. Those are briefly narrated below:

(1) Customs duties

(a) The additional resource mobilisation effort has been focused on customs duties and it has been decided to impose a uniform surcharge of 5% on the C&F value of all imports except accompanied baggage and post parcels, books and medicines. As a 5% surcharge will also be levied on imported crude, excise duties at the same rate will simultaneously be levied on local crude to maintain parity between the two.

(b) In order to pass on the effect of the 5% levy being imposed on crude as well as the higher rupee cost of petroleum products as a result of delinking the dollar-rupee exchange rate, it has been decided to adjust the prices of P.O.L. (Petroleum, oil and lubricants) products upward. Essential products like kerosine, light diesel oil and furnace oil are not subject to any increase. These items will remain exempt from surcharge at the import stage also.

(c) The following concessions have been allowed to the engineering industry:

- locally made engineering goods supplied to organizations and projects entitled to duty-free or concessional imports have also been extended the facility of repayment of duty and taxes as admissible for export, i.e. refunds of import duty paid on the raw material used in the manufacture of goods so supplied;
- the duty concessions available to principal manufacturing units will also now be available to their recognised and registered vendors;
- engineering units providing complete and near complete industrial plants manufactured against confirmed orders from abroad shall be eligible for duty-free importation of specified quantities of raw materials and components for the execution of such export orders;
- jigs, tools and dies required by the engineering industry have been exempted from import duty;
- a benefit of a 20% concessionary rate of duty has been allowed on importation of billets for manufacture of wire rod.

(d) To help local industry to cope with the problem of power shortages and breakdowns, generators of 650 KVA and above imported for industrial use have been exempted from duty and sales tax.

(e) To encourage the local manufacture of various items at competitive prices, duty on the following inputs has been reduced;
- soda ash: from 150% to 85%;
- soya bean meal: from 40% to 10%;
- methanol: from 85% to 40%;
- lead scrap: from 40% to 20%;
- tyre-cord fabrics: from 50% to 30%;
- clock movements: from 85% to 40%.

(f) To improve the quality of ginning in the country, duty-free import of pre-cleaning equipment, linter cleaning equipment and saws for saw gins for the balancing, modernization and replacement of the ginning industry has been allowed.

(g) The regulatory duty of 100% on wire hoalds and reeds has been withdrawn for the benefit of the local textile industry.

(h) The duty on mosquito coils has been reduced from 70% to 40%. Mosquito mats will also be liable to the same rate of duty.

(i) To protect the interests of local industry engaged in the manufacture of polypropylene nylon twine and twine from raw material suffering a higher incidence (i.e. 13 Rs. per kg., which in ad valorem terms comes to about 200%), the duty on polyropylene and nylon ropes and twine has been increased up to 85% to offset the disadvantage to the local industry manufacturing fishing twine, which is free of duty on import. Provisions have been made for refund of duty paid on raw materials used in such locally manufactured product.

(j) To provide protection to the local industry, duty has been increased on:
- natural graphite: from 30% to 40%;
- cement: from 20% to 25%;
- carbon paper sheets: from 50% to 70%;
- duplex board: from 50% to 4,000 Rs. per metric ton;
- abrasive bricks: from 50% to 85%;
- asphalt heating machines and milling and boring machines: from 40% to 85%;
- theodolite and levels: from 0 to 40%.

(k) The refund facility available to the plywood and chipboard industry on the import of urea formaldehyde resin in excess of 30% of duty has been withdrawn in the interest of local industry manufacturing this item. It will now be subjected to a duty of 9.10 Rs. per kg. as against the statutory rate of 13 Rs. per kg. To safeguard the interest of the local plywood industry, duty on imported plywood has been increased from 200% to 250%.

(l) The duty on switchboard and pressure control panels up to 11,000 volts has been raised from 40% to 85% in line with the rate applicable to switch gears.

(m) Tractor assemblers were allowed the facility of import of all spare parts at 10% duty during Fiscal Year 1981/82. As radiator cores of good quality are now being manufactured in the country, this item has, therefore, been excluded from the purview of the 10% duty concession to protect local industry.

(n) For rationalising the duty on cassettes vis-à-vis the components, i.e. magnetic tapes and plastic cases, these components have been subjected to a uniform rate of import duty of 120% plus 20% sales tax. All cassettes, whether blank or recorded, will, however, be subject to duty of 10 Rs. per cassette.

(o) The duty on compressors for replacement purposes has been reduced from 70% to 40%, thus subjecting all compressors to 40% duty.

(p) Lifts, air-conditioning plants and operating theatre equipment imported by private hospitals, clinics and nursing homes with a minimum capacity of 25 beds have been exempted from duty.

(2) Central excise duties

(a) During Fiscal Year 1981/82, sugar produced in a factory which was in excess of its average production for the preceding 4 years was exempt from duty. In order to rationalize the above-mentioned incentive on a more realistic basis, it has been decided that during Fiscal Year 1982/83, sugar produced in a factory which is in excess of its average production for the preceding 2 years will be exempt from duty.

(b) The existing policy towards beverages has been reviewed and a comprehensive taxation policy has been framed with the following objectives in view:
- agro-based aerated waters and other beverages such as syrups, squashes and fruit juices should receive preferential treatment over beverages of synthetic origin;
- among aerated synthetic beverages, nationally formulated drinks should receive preferential treatment over international franchise drinks.

Agro-based beverages were already exempt whereas aerated beverages of synthetic origin were chargeable to a uniform central excise duty of 50 paisas (i.e. 0.50 Rs.) per ordinary bottle irrespective of whether the beverages were nationally formulated or not. In order to accord preferential treatment to nationally formulated drinks over international franchise drinks, the rate of duty in respect of international franchise drinks has been raised from 50 to 75 paisas per ordinary size bottle.

(c) The existing central excise duty on cigarettes consisted of a two-slab structure which was linked to the retail price. Cigarettes of retail price up to 60 paisas (i.e. 0.60 Rs.) per 10 cigarettes were chargeable to a lower rate of duty which ranged from 46% to 48% of the retail price. Cigarettes priced above 60 paisas per 10 cigarettes were chargeable to a higher rate of duty which ranged from 64.23% to 70.78% of the retail price. Pursuant to the Government's policy to discourage smoking, the rate of duty on cigarettes was enhanced by 20% during Fiscal Year 1980/81. This increase in excise duty coupled with the anti-smoking campaign had the desired effects and the overall growth in the consumption of cigarettes declined. The decline was, however, larger in the case of cigarettes priced above 60 paisas per 10 cigarettes, indicating a shift to the lower slab cigarettes. It has been decided, through the Budget for Fiscal Year 1982/83, to increase the incidence of duty presently ranging from 46%–48% of the retail price to 50% of the retail price. Simultaneously, the excise barrier has been raised from 60 paisas to 70 paisas per 10 cigarettes.

(d) Imported pigments, namely, congo red, direct deep black and carbon black, being cheaper than the local products, its was becoming uneconomical for local industry to compete with such pigments. Therefore, in order to enable locally produced pigments to compete with imported ones, the rate of central excise duty on the aforementioned pigments has been reduced from 22% to 10% of the retail prices.

(e) In the case of goods chargeable to central excise duty on a retail price basis, the manufacturers have to take into account the element of octroi (i.e. local taxes levied by the municipal administration at the entry point of the goods in the municipal limits of a town or city) at the highest rate prevailing in the country while fixing the retail price. This works to the disadvantage of consumers in low or non-octroi areas. Besides, it does not seem fair to call upon people living outside the octroi limits to bear the octroi burden. It was, therefore, decided to amend the exsting legal provisions so as to exclude the element of octroi from the definition of the retail price.

(3) Sales tax

(a) The cottage industry plays a vital role in the economic development of a country. In order to encourage the cottage industry sector to perform its due role, the limit of "capital employed" for cottage industry exemption has been raised from 50,000 Rs. to 100,000 Rs.

(b) In view of the disorganizing impact of the cottage industry sector on the organized sector, the cottage industry exemption available to manufacturers of gas apparatus and appliances, sanitary ware and foam and foam products (which have large turnovers and have outgrown the cottage industry level) has been withdrawn.

(c) Sodium silicate is used as a raw material for the manufacture of soaps, washing preparations, paper and paper board and glass and glassware. In order to provide relief to consumers, the rate of sales tax on sodium silicate has been reduced from 12.5% to 7.5%.

(d) While insecticides and pesticides meant for agricultural purposes were exempt from sales tax, the same for household use were not exempt. This anomaly has been removed by exempting the latter through the Budget for Fiscal Year 1982/83.

(e) The levy of sales tax on local industry engaged in the manufacture of wall clocks and welding electrodes has been abolished in order to enable these nascent industries to grow.

(f) The levy of sales tax on the import of primary and secondary plastic materials has been rationalised. A sales tax of 10% will now be leviable on secondary stage materials instead of primary plastic raw materials which shall be exempt from sales tax. This measure is expected to provide the local plastic goods industry a relief to the extent of 2 Rs. per kilogram on its raw materials.

(g) A sales tax of 10% has been levied on imported natural graphite.

(h) Imported methanol has been exempted from sales tax.

(4) Income tax

The Income-tax law has been amended to give certain concessions and bring about the following changes to meet the requirements of developing private sector investment:

(a) In pursuance of the various steps taken to replace interest bearing arrangements with the scheme of profit sharing, the Government had empowered the House Building Finance Corporation (i.e. a government body entrusted with the task of advancing loans to prospective builders of residential houses) to share rental income on the amount lent by it instead of charging interest thereon. Accordingly, a provision has been made in the Income-tax Ordinance, 1979 to the effect that the share of rental income paid to the House Building Finance Corporation or scheduled banks on capital contribution by them under an income sharing scheme will be an admissible deduction in computing income from house property. A specific provision for not treating the return of capital or the principal amount as a deductible expense has also been made.

(b) Pursuant to the policy of the Government to empower banks and financial institutions to undertake the financing of industry on the basis of "finance leasing", specific provision has been made to enable banks and financial institutions to claim initial depreciation at the rate of 40% on leased assets. Nevertheless, the assets on lease shall not entitle the lessor to claim normal depreciation.

(c) The profit payable to the State Bank of Pakistan for providing financing to the House Building Finance Corporation on a profit and loss-sharing basis has been allowed as a deduction in computing the profits of the latter.

(d) In order to facilitate the rehabilitation and rejuvenation of the sick sector, an assessee owning any industrial unit declared "sick", and in respect of which a scheme of rehabilitation with the approval of the Federal Government is being pursued, can carry forward the business losses relating to such units from assessment year 1976/77 onwards for 10 years instead of the otherwise statutory period of 6 years.

(e) The maximum limit of the investment allowance has been raised from 45,000 Rs. to 50,000 Rs. This amendment in the Income-tax Ordinance, 1979 shall be effective from assessment year 1983/84. Consequently, the benefits of the increased ceiling will be available in respect of investments made during the income year corresponding to assessment year 1983/84.

(f) The scheme of advance payment of tax as contemplated under the Income-tax Ordinance, 1979 required assessees, whose total income of the latest completed assessment on the date the first instalment of the advance tax became due was 25,000 Rs. or more, to pay advance tax in 4 quarterly instalments. The ceiling of 25,000 Rs. was originally fixed by the Finance Act, 1956 and was persistently felt to be long overdue for upward revision. Accordingly, it has now been raised to 50,000 Rs. for all assessees other than companies. Simultaneously, through another amendment, total income of the assessee for the latest assessment year shall exclude income represented by interest on securities for the payment of advance tax. In case of non-residents, dividend income shall be excluded from total tax for the purposes of advance tax payments.

(g) The concept of tax credit was introduced through the Finance Act, 1976. Under this scheme, the investing company was entitled to a tax credit of 15% to 30% in respect of the amounts invested in the purchase of shares of any other Pakistani company setting up an approved industrial undertaking in the specified area. The tax credit was admissible only after the industrial undertaking had been set up. This anomaly has been removed by allowing the tax credit in the year of investment irrespective of the year of setting up the industrial undertaking. In order to take advantage of the tax credit, the investing company was obliged to retain its investment for a period of at least 5 years from the date of purchase of shares, as otherwise the tax credit was liable to be remitted. Whereas the 5-year retention period continues, an amendment has been introduced to the effect that the investing company will also be liable to adverse tax incidence in case any of the following events takes place:

- if the approved industrial undertaking is not set up within the specified period;
- if the approved industrial undertaking is set up in an area other than that specified in the order of approval;
- if the approved industrial undertaking has not announced commercial production within the specified period.

(h) The rates of supertax on intercompany dividends paid by a Pakistani company have been reduced in the following manner:

– where dividends are received by a public company and paid by a Pakistani company in respect of shares issued in Pakistan after 14 August 1947	5%
– where dividends are received by a corporate body incorporated outside Pakistan or a foreign association declared to be a company by the Central Board of Revenue	15%
– in all other cases	20%

(i) The limit of maximum free reserves, the excess over which triggered a flat 5% surcharge, has been enhanced from 1.5. times the paid-up capital to 2 times the paid-up capital in the case of companies other than banking companies. The limit of 3 times the paid-up capital in cases of banking companies and approved financial institutions remains unchanged.

(j) The existing law provides the levy of a 10% surcharge in respect of taxpayers, other than companies, whose taxable income exceeds 50,000 Rs. This limit of 50,000 Rs., as originally fixed by the Finance (Amendment) Ordinance, 1978, has now been raised to 100,000 Rs.

(k) A long awaited demand of investors in shares of private limited companies (i.e. closely held companies) has been met by exempting dividend income up to 5,000 Rs. received by an assessee (not being a company) from a company not listed on a stock exchange in Pakistan. The overall exemption limit of 15,000 Rs., nevertheless, remains unchanged. This provision is operative from assessment year 1983/84.

(l) Previously, dividend income received by an assessee (not being a company) from specified public companies registered under the Companies Act, 1913 between 1 July 1977 and 30 June 1982 was exempt for a period of 5 years from the year of commencement of commercial production. This exemption has now been made available on dividend income from such public companies registered up to 30 June 1983.

(m) Dividend income received by an assessee (not being a company) from open and closed mutual funds or any investment company registered under the Investment Companies and Investment Advisers Rules, 1971, and listed on the stock exchange, out of capital gains has been exempted with effect from the assessment year 1983/84. This exemption is in addition to the existing exemption of dividend income of 15,000 Rs. otherwise available under sub-clause (a) of clause 80 of the Second Schedule to the Income-tax Ordinance, 1979.

(n) The tax holiday period has been extended to 30 June 1985 in respect of income from the businesses of poultry farming, fish catching, cattle and sheep breeding, poultry processing, dairy farming expiring on 30 June 1983 and of fish farming expiring on 30 June 1982.

(o) The period of exemption for bonus shares in the hands of the issuing company expiring on 30 June 1982 has been extended up to 30 June 1983.

(p) Previously, certain classes of persons, viz. the Government, a local authority, a public company (both listed and unlisted on the stock exchange), a foreign contractor or consultant or consortium, were required to withhold tax on payments made in lieu of the execution of a contract or supply of goods or provision of services, etc. The Budget for Fiscal Year 1982/83 has extended the withholding tax net and has made it obligatory on a private limited company with a paid-up capital of not less than 3,000,000 Rs. to withhold tax from payments made thereof under the circumstances and at rates applicable to the other classes of persons.

(5) Gift tax

The Gift Tax Act provided that a gift up to a maximum of 50,000 Rs. made by a person to his or her spouse during the life time of that person was tax exempt. While the existing exemption continues, the amendment made through the Finance Ordinance, 1982 further exempts from the levy of gift tax one residential house (whether self-occupied or rented out) gifted to his or her spouse. This exemption is available to the donor only once in his or her life time regardless of the value of the house.

Political Contributions by Companies in India

Legal Limitations and Tax Traps

By Har Govind

India, the world's largest parliamentary democracy, has a regular election process at work. This underscores the importance of political donations by companies. The public debate on this subject is now confined to two issues. One view is in favour of permitting companies to make political donations within certain monetary limits and the other is for a total ban. However, the objection is limited only to political contributions by companies since there is no serious objection against such contributions by individuals. A chronological study of the main legislative and administrative measures under the Companies Act, 1956, the Income-tax Act, 1961 and the Gift-tax Act, 1958 has been attempted in this study.

CURRENT SITUATION

1. Contributions made by companies to political parties are prohibited under the Companies Act but in practice the prohibition is often circumvented.
2. Contributions made by business – including companies – to political parties are generally not deductible for income tax purposes as a business expense.
3. Donations made by companies to political parties are generally subject to gift tax.

I. COMPANIES ACT

The present Companies Act was consolidated in 1956. Before its amendment in 1960, there was no specific section enabling a company to make a contribution to a political party or for a political purpose. Consequently, companies had no provision in their memoranda and articles of association for making contributions to political parties or for political purposes. To make such a donation, a company had to take steps to amend its memorandum with the permission of the High Court. Several High Courts, however, expressed concern about the dangers of permitting companies to make political contributions by amending their memoranda and their pronouncements attracted wide public attention. This issue was also raised in Parliament and the ensuing debates and write-up in the press reflected the prevalent adverse public opinion. Government, therefore, brought in an amendment to the Companies Act in 1960 by adding a new Sec. 293A. The main features of this new section as originally inserted were:

(i) a company was permitted to contribute to political parties or for political purposes an aggregate amount up to 25,000 Rs. or 5% of its net profits in the last 3 financial years, whichever was higher;
(ii) a company was required to disclose in its profit and loss account the details of such contributions; and
(iii) failure to disclose attracted a fine up to 5,000 Rs. for the company and every officer thereof who was responsible for the default.

Total ban

The above regulatory restrictions did not prove adequate. Powerful voices were raised in favour of a total ban on company donations. The Committee on Prevention of Corruption headed by Mr. K. Santhanam in paragraph 11.5 of its Report of 31 March 1964 observed:

> In Indian conditions, companies should not be allowed to participate in politics through their donations. It is true that this matter was debated at length during the discussion on the Companies (Amendment) Act of 1960 and it was decided to permit such donations subject to restriction of amount and condition of publication. We do not think that this is sufficient and feel that nothing but a total ban on all donations by incorporated bodies to political parties and purposes will clear the atmosphere.

Criticism of political donations was also made by the Hazari Committee. It reported that more than 85% of industrial licences had been cornered in the past by only a few business houses in return for handsome donations. A private member moved a Bill in the Lok Sabha (House of People) in 1967 seeking a complete ban on political donations by companies. The debate on the Bill disclosed great concern amongst members of Parliament. Though the private Bill was withdrawn, Government itself moved in the matter. Sec. 293A, introduced in 1960, was replaced by a new Sec. 293A in 1969. A complete prohibition was introduced in respect of contributions by companies to political parties or for political purposes to any individual or body. The provisions of the amended Sec. 293A provided the following stricter penalties for their contravention:

(i) The company was punishable with a fine up to 5,000 Rs.
(ii) Every officer of the company in default was punishable with imprisonment for a term up to 3 years and was also liable to a fine.

It may be noted that any officer in default was punishable with imprisonment as well as a fine. There was no monetary limit under the law on the amount of the fine.

Review of ban

In actual practice, the total ban, introduced in 1969, was avoided by indirect means such as payment of disproportionately high rates for advertisement space in party newspapers, periodicals or souvenirs. These payments, though in substance contributions to political parties or for political purposes, could not be strictly termed as such and did not provide sufficient grounds for successful prosecution in a court of law. The Calcutta High Court decided in the case of Graphite India Ltd. (48 Comp. Cas. 683) that expenditure on advertisements in souvenirs of political parties did not amount to a political contribution. Following the meaning attributed to the term "contribution" in West's *Words and Phrases,* the High Court held that "contribution" means giving money or other aid for a specified object. Payment for an advertisement cannot be treated as a contribution if some benefit by way of publicity is derived. The emergence of the practice of high payments for advertisements and the trend of Court rulings led Government to re-examine the efficacy of the total ban on political donations by companies.

To evolve a pragmatic approach, a Bill was introduced in the Lok Sabha on 24 August 1976 enabling non-Government companies to make political contributions with certain limits. However, the Bill could not secure quick passage. It lapsed with the dissolution of the Lok Sabha in 1977 and has not been revived.

Sachar Committee's report

The High Powered Expert Committee on Companies and Monopolies and Restrictive Trade Practices Acts headed by Mr. Justice Rajendra Sachar, in its Report dated 29 August 1978, has dealt with the question of political donations in detail. The Committee concluded that the existing prohibition embodied in the Companies Act on political contributions should continue. It also suggested further strengthening of the Companies Act, 1967. It recommended that the meaning of the expression "political purpose" should be clarified in the Act itself by adding an explanation. Expenses incurred by a company – including expenditure on advertisements in souvenirs, brochures, tracts, pamphlets or similar publications of a political party – directly or indirectly should be deemed to be contribution for a political purpose.

Follow-up action

Bearing in mind the Sachar Panel's Report, an Ordinance was issued on 25 September 1979. In terms of the ordinance, any expenditure incurred, whether directly or indirectly, by a company on advertisement in any souvernir, brochure, pamphlet or the like published by or on behalf of a political party was deemed a contribution for political purposes. The punishment for contravention of any provision of Sec. 293A of the Companies Act by a company was a fine up to 5,000 Rs. Every officer of the company who made or authorised such contravention was punishable with imprisonment for a term which could extend to 3 years and was also liable to a fine. The Companies (Amendment) Ordinance, 1979 was promulgated on 25 September 1979. Under Art. 123 of the Constitution of India, every Ordinance shall be laid before both Houses of Parliament and shall cease to operate at the expiration of 6 weeks from the reassembly of Parliament. The 1979 Ordinance was not laid before Parliament and since the new Parliament re-assembled on 20 January 1980, the Ordinance lapsed 6 weeks thereafter, i.e. on 2 March 1980. Thus it remained in force only for a short period of 159 days and since the 2 amendments proposed in 1976 and 1979 failed to secure Parliament's approval, the legal ban on company donations continues to hold the field in the form embodied in Sec. 293A as enacted in 1969.

II. THE INCOME-TAX ACT

Provisions relating to donations and contributions made by companies to political parties and for political purposes are to be found in more than one section of the Income-tax Act, 1961, such as Secs. 80G and 37. There is also a catena of case law on the subject. The important provisions may be briefly noted here.

To claim the benefit of full deductions as business expenditure under Sec. 37(1) of the Income-tax Act in respect of a donation made by a company, it must be established that it is an expenditure laid out or expended wholly and exclusively for the purpose of the business. It is necessary to show that the contribution was made for earning profits and not made out of profits. In deciding whether a payment of money is for the purpose of the business and is admissible as a deduction in computing the taxable profits, the Courts have generally applied the test of "commercial expediency" and principles of ordinary commercial trading. This test was first articulated with precision by Lord Cave L.C. in his celebrated dictum in the case of Atherton v. British Insulated and Helsby Cables Ltd. ((1926) AC 205: 10 T.C. 155). It has since been followed in many cases ending with the recent decision of the Madhya Pradesh High Court in Addl. Commissioner of Income-tax v. Kuber Singh Bhagwandas ((1979) 118 I.T.R. 379 (M.P.)). The full Bench of the High Court has comprehensively summarised the law on the subject. Dealing with the words, "money wholly and exclusively laid out or expended for the purposes of the trade", Lord Cave observed in the Insulated Cables case that a sum of money expended not out of necessity or for the direct and immediate benefit of the trade but voluntarily and on grounds of "commercial expediency", and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade.

Donations to political parties are generally not allowed by the tax authorities and the Courts. It is always difficult for a company to establish a nexus between the donation and business of the assessee. Even though a contribution by a company to a political party may not be hit by the provisions of Sec. 293A of the Companies Act, the Courts will not automatically assume that the contribution was made for commercial expediency. Each case will have to be decided on its own merits. The onus of establishing the existence of commercial expediency will be on the assessee. Generally speaking, donations to election funds of political parties have not been allowed by the Courts as business expenditure. For a representative decision on this type of donation, reference is made to the case of Indian Steel and Wire Products Ltd. v. Commissioner of Income-tax ((1966) 69 I.T.R. 379). On the other hand, contributions made for carrying out a campaign against a Government proposal to ban the manufacture of a particular commodity or for an anti-nationalisation campaign have been held to be allowable expenditure. Two leading Indian cases on this subject are Delhi Cloth and General Mills Co. Ltd. v. Commissioner of Income-tax ((1972) 85 I.T.R. 261), and Ambala Bus Syndicate (P) Ltd. v. Commissioner of Income-tax ((1974) 95 I.T.R. 383). Stated briefly, a contribution by a company to a political party whether hit by Sec. 293A of the Companies Act, or not, has to independently satisfy the test of "commercial expediency" to be treated as admissible expenditure under the Income-tax Act. In addition, the company has also to provide separately that it is not a "gift" within the meaning of the Gift-tax Act and no gift tax is payable by it.

Expenditure on advertisement

The present Sec. 37(2B), which came into effect from 1 April 1979, provides that expenditure incurred by an assessee for purposes of advertisement in any souvenir brochure, tract, pamphlet or the like published by a political party shall not be allowed as a deduction in computing the taxable profits. This new provision specifically says that such allowance shall not be made notwithstanding anything contained in the omnibus sub-section (1) of Sec. 37 which permits allowance in respect of any non-capital non-personal expenditure laid out wholly and exclusively for the purpose of the business. Though the Companies (Amendment) Ordinance, 1979 has lapsed, sub-section (2B) of Sec. 37 which was also part of the follow-up action emanating from the Sachar Report has received Parliamentary sanction to stand on the statute book.

Political donation v. charity

Sec. 80G of the Income-tax Act, as it stands at present, provides for a deduction in the computation of a taxpayer's total income of a sum equal to 50% of the donation made by him to certain funds or charitable institutions, or for repair or renovation of any temple, mosque, gurdwara, church or any other place which is notified by the Central Government or any such local authority, institution or association as is approved in this behalf by the Central Government. The amount of deduction is, however, limited to 10% of the gross total income of the donor, subject to a further monetary limit of 500,000 Rs. These ceiling limits do not apply in relation to donations made to certain National Funds specified in the section. Explanation 5 to Sec. 80G specifically provides that deduction is admissible under that section only if the donation is of a sum of money. A donation in kind does not qualify for deduction. A "charitable purpose", as defined in Sec. 2(15) of the Income-tax Act, includes relief to the poor, education, medical relief, and the advancement of any other object of general public utility not involving the carrying out of any activity for profit. Explanation 3 to Sec. 80G lays down that for the purpose of Sec. 80G "charitable purpose" does not include any purpose the whole or substantially the whole of which is of a religious nature. A political party is not a charitable institution. A political purpose cannot be termed a charitable purpose. A donation to a political party, therefore, does not qualify for a deduction under Sec. 80G.

III. GIFT-TAX ACT

A company is liable to gift tax under the Gift-tax Act, 1958. This extends to the whole of India except the State of Jammu and Kashmir. Charging Sec. 3 of the said Act lays down that gift tax shall be charged in respect of gifts made by any "person". The term "person" as defined in Sec. 2(xviii) of the Gift-tax Act includes a Hindu undivided family or a "company" or an association or body of individuals or persons, whether incorporated or not. A company is defined in Sec. 2(vii) as follows:

> "Company" means a company as defined in section 3 of the Companies Act, 1956, and includes:
> (a) a foreign company within the meaning of section 591 of that Act; and
> (b) a company within the meaning of any law relating to companies for the time being in force in the Union territory of Dadra and Nagar Haveli, Goa, Daman and Diu or Pondichery and any association in any such Union territory whether incorporated or not which is declared by general or special order of the Board to be a company for the purposes of this Act.

The foreign company referred to in (a) above is a company incorporated outside India which has a place of business in India. A Jammu and Kashmir company would not be liable to gift tax unless it established a place of business in the rest of India within the meaning of Sec. 591 of the Companies Act.

Exempt companies

Sec. 45 of the Gift-tax lays down that the Act does not apply to gifts made by:

(a) a Government company that is a company in which not less than 50% of the paid-up share capital is held by the Central or any State Government and a subsidiary of such company;
(b) a corporation established by a Central or State or Provincial Act;
(c) any company other than a private company as defined in Sec. 3 of the Companies Act provided that the affairs of the company or shares in the company carrying more than 50% of the total voting power were at no time during the previous year controlled or held by less than 6 persons;
(d) a company which is a subsidiary of and in which more than half the nominal value of equity share capital is held by a company referred to in (c) above.

To be entitled to an exemption under the Gift-tax Act, it is not sufficient that a company is a public company within the meaning of Sec. 3 of the Companies Act. it has to satisfy the criteria laid down in Sec. 45(c) of the Gift-tax Act.

Concept of gift

A gift has been defined in Sec. 2(xii) of the Gift-tax Act.

It means the transfer by one person to another of any existing movable or immovable property, made voluntarily and without consider consideration in money or money's worth. It also includes the transfer or conversion of any property deemed to be a gift under Sec. 4 of the Gift-tax Act. The subject matter of the transfer must be existing property as distinguished from future property. Money or money's worth means valuable consideration. Gold, jewels, shares, securities, movable goods, immovable propert, etc. which on sale can fetch money are called money's worth. The second part of the definition which brings deemed gifts within the purview of the Gift-tax Act covers 6 categories of gifts. They are: (i) transfers for inadequate consideration; (ii) transfers where the consideration has not passed or is not intended to pass either wholly or partially; (iii) a release, discharge, surrender, forfeiture or abandonment of any interest in property for reasons which are not bona fide; (iv) transfers to a joint account of the taxpayer and another person from which such other person makes appropriation for his own benefit; (v) conversion of separate or self-acquired property into Hindu undivided family property; and (vi) where a beneficiary of a trust exercises the power of appointment conferred on him under the trust deed and releases his or her life interest in the trust in favour of other persons. The term "transfer of property" as defined in Sec. 2(iv) of the Gift-tax Act has a wide connotation. All movable and immovable property except property specifically exempted under Sec. 5(1) is within the scope of the Gift-tax Act. Agricultural lands and buildings are also subject to gift tax and gift tax on agricultural property is constitutionally valid (I.T.O. v. D.H. Nazarath (76 I.T.R. 706 S.C.)).

It may be noted here that a deemed gift by a public company to an Indian company under a scheme of amalgamation is exempt under Sec. 45(da).

Aggregation of gifts

A new Sec. 6A was inserted in the Gift-tax Act from 1 April 1976. It provides that all gifts, whether made to the same donee or different donees in the preceding 4 years, are to be aggregated with the taxable gifts made in the previous year with the stipulation that gifts made before 1 June 1973 shall not be taken into account for the purpose of aggregation. Under the scheme of aggregation in Sec. 6A, gift tax is first calculated on the aggregate of taxable gifts of the previous year and the gifts made during one or more of the 4 previous years immediately preceding such previous year at the rate applicable to the assessment year. From this gross gift tax, the tax payable on the value of the gifts made during one or more previous years immediately preceding the previous year at the rate applicable to the assessment year is deducted to arrive at the net tax payable for the assessment year.

Political donations and gift tax

A number of High Courts have held that donations to political parties cannot be said to be laid out for the purpose of business (e.g. Orissa Cement Ltd. 73 I.T.R. 14). The Supreme Court also expressed a similar view in the case of Ghee Verghese (83 I.T.R. 403 S.C.). Sec. 293A of the Companies Act which had permitted donations and contributions to political parties within prescribed limits was also amended by the Companies (Amendment) Act, 1969 and such contributions made after 2 April 1970 were prohibited. As a result of the above judicial decisions and amendment to the Companies Act, the prevailing view now is that donations to political parties are not exempt from gift tax. They are treated as voluntary payments without consideration for money or money's worth. Accordingly, donations by a company to political parties are not only taxable, they are also agreeable under Sec. 6A. Under the Gift-tax Act the rate schedule is common for all assessees. A company is also liable to progressively higher tax on aggregation of gifts made by it. Whether a contribution by a company to a political party is hit or not by Sec. 293A of the Companies Act, the company will have to separately satisfy the Gift-tax Officer that the contribution made by it is not a "gift" or even if it is a "gift" it is exempt under Sec. 5(1)(xiv) of the Gift-tax Act. Where a company is punished under Sec. 293A of the Companies Act, it may be an uphill task for it to escape liability under the Gift-tax Act.

IV. SUGGESTIONS FOR REFORM

(1) The question of admissibility under the Income-tax Act or exemption under the Gift-tax Act in respect of donations by companies to political parties invariably gives rise to differences of opinion and, consequently, litigation starts. There is no presumption that a donation by a company which does not attract the provisions of Sec. 293A of the Companies Act is admissible under the Income-tax Act or exempt under the Gift-tax Act. There is also no presumption that a donation which falls within the purview of Sec. 293A is automatically inadmissible for computing taxable income or is liable to gift tax. The issue has to be decided on its merits separately under each Act. To minimise multiplicity of proceedings and reduce time-consuming and costly litigation, it is desirable to evolve a coordinated treatment under the Companies Act, the Income-tax Act and the Gift-tax Act. A donation which is not hit by Sec. 293A of the Companies Act should be allowed as an expenditure under the Income-tax Act. It should also be exempt from gift tax.

(ii) Sub-section (2B) of Sec. 37 which disallows expenditure on advertisement in publications of political parties was introduced with effect from 1 April 1979 as a parallel enactment to the Companies (Amendment) Ordinance, 1979. Since that Ordinance, which was designed to make a similar provision in the Companies Act, has lapsed for want of legislative support. Sec. 37 (2B) of the Income-tax Act should also be withdrawn to harmonise the Income-tax Act with the Companies Act.

(iii)The pragmatic proposal which was mooted in 1976, to permit non-Government companies to make political contributions within specified limits, needs to be revived. It deserves to be implemented with practical safeguards.

(7) Labor and social security rules

The relationship between the Cuban personnel, the Cuban entity which directly employs them and the corporate joint venture, as well as their respective rights and obligations, are laid down.[6]

(8) Customs clearing procedure

Joint ventures and the members of other types of business associations may freely export their production and import the necessary goods and merchandise to fulfill their objectives. To this end, a clearing procedure through customs is established.[7]

III. Taxation of joint ventures

(1) Deductions

In determining the taxable base, the annual gross income and capital gains are reduced by the ordinary costs and the expenses necessary to produce such income incurred during the calendar year. Ordinary costs and necessary expenses include:

(a) *Depreciation allowances:*

The following maximum percentages may be deducted from the acquisition value and installation costs of tangible business assets (excluding land), in consideration of their depreciation:

Type of asset	*Depreciation allowance %*
Wooden buildings and constructions	6
Concrete, masonry, iron and steel buildings and construction	3
Office furniture and fixtures	10
Data processing equipment, air transport equipment and mechanized equipment for construction or agriculture	25
Sea transport equipment, railway transport equipment and machinery in general	6
Land transport equipment	20
Films and video cassettes	25

(b) *Miscellaneous deductions:*

Also deductible are, among other things:
Industrial and copyright royalty payments, and interest on domestic and foreign bank loans;
Experiment and research costs over a maximum period of 5 years;
Bad debts and losses incurred by any sort of calamity;
State taxes other than the corporate tax on net profits (levied at a 30% rate);
Losses accumulated from prior years, which can be apportioned over the next following 5 years;
Allocations to capital increases;
Allocations to the legal, statutory and voluntary reserve accounts;
Allocations to the economic incentive fund for Cuban personnel.[8]

(2) Tax auditing

It is mandatory to keep the financial records in the Spanish language and to file with the State Finance Committee (i) a quarterly balance-sheet on 1 April, 1 July, and 1 October of each calendar year and to submit (ii) the final balance-sheet, together with the annual tax return and the payment of the tax liability, before 1 March of the next following year.

IV. Remittance abroad of income earned by foreign personnel

The remuneration earned by foreign personnel in consideration for services rendered to joint ventures or to the parties in other types of business associations must be paid by employers into a current account opened with the Central Bank or any other domestic banking institution in favor of that personnel. Foreign personnel may then open a deposit account whose interest income is also free of tax, or they may remmit abroad, in convertible currency up to 66% of the total remuneration and the total interest received with respect to that deposit account.[9]

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6. Resolution of the State Labor and Social Security Committee 1,647/82 of 15 September 1982, implementing Arts. 36 to 42 of DL 50/82.
7. Resolution of the Customs General Directorate 1/82 of 15 September 1982, implementing Art. 31 of DL 50/82.
8. Resolution of the State Finance Committee 52/82 of 15 September 1982, implementing Arts. 26(a) and (b), 29 and 30 of DL 50/82. There are some other deductible items listed in this Resolution.
9. Resolution of the Central Bank 659/82 of 15 September 1982, implementing Art. 44 of DL 50/82.

CUBA: Supplementary Regulations on Taxation of Joint Ventures

By M.A. Gª.Caballero

I. Introduction

Decree-Law 50/82 of 15 February 1982 on joint ventures and other types of business associations (the salient points of which were summarized in 36 *Bulletin for International Fiscal Documentation* 10 (1982) at 445-446) authorized the pertinent bodies of the State Central Administration to issue the necessary regulations to implement several aspects of the Decree-Law. These regulations were issued on 15 September 1982 in the form of Administrative Rulings relating to (i) the investment and labor requirements, (ii) the taxation of joint ventures and (iii) the remittance abroad of income earned by foreign personnel.

The most important features of the rulings are described below.

II. Investment and labor requirements

(1) "Negative" certificate

Before a joint venture is incorporated, a "negative" certificate, issued by the newly created Registry for Business Associations of the Chamber of Commerce, must be obtained. The negative certificate states that the proposed corporate name is not already used by an existing company.

(2) Foreign contribution

The consideration paid by foreign investors may be in foreign currency or in kind. However, loans raised from Cuban sources may not be used as contribution.[1]

(3) Legal reserve account

A corporate joint venture must have a legal reserve account the balance of which must represent at least:
(i) 15% of the paid-up capital in case of manufacturing joint ventures, or (ii) 20% of the paid-up capital, in case of joint ventures whose business activities consist of rendering services;
until this percentage is reached, at least 5% of the annual profits must be allocated to the account. The account may only be used for compensating losses or liabilities, if any, of the corporation, in which case the amount used must be paid back into the account in amounts representing at least 10% of the annual profits.[2]

(4) Borrowing power

Joint ventures, as well as the parties in other types of business associations, raise funds to finance their business activities from foreign as well as domestic sources. In the case of foreign loans, however, these cannot be denominated in US$ "rebus sic stantibus" (in these circumstances); a guarantee from the Central Bank may be obtained for foreign loans denominated in any other type of currency. As far as domestic loans are concerned, these may be obtained from the Central Bank or from any other domestic banking institution; the amount of the loan is proportional to the net worth of the business association, which is to be given as collateral, and the maturity date, as a rule, will not exceed 12 months; exceptionally, however, maturity dates exceeding 12 months may be negotiated, especially for loans used to finance investments. Furthermore, it is mandatory to insure the asset inventory given as collateral with ESICUBA (the national enterprise for international insurance).[3]

(5) Insurance of leased installations

Industrial, tourist or any other type of installation leased to or used by joint ventures must be insured by the leasee or user in favor of the Cuban lessor to cover possible calamities from fire and/or lightning, hurricane, cyclone, tornado, etc., flooding, and in seismic areas from earthquake and eventual fire.[4]

(6) Registration and fees

The articles of incorporation and bylaws of joint ventures and the deeds through which other types of business associations conclude their agreements are to be registered in the newly created Registry for Business Associations of the National Chamber of Commerce.

The following registration fees are payable in Cuban pesos:[5]

Entry into the Daily Registry Book	50
Registration of a joint venture	500
Registration of other types of business associations	400
Other types of entries, and amendments to the original registration	100
Registration certificate	100
Partial and "negative" registration certificates	50

1. Resolution of the Central Bank 660/82 of 15 September 1982, implementing Art. 21 of DL 50/82.
2. Resolution of the State Finance Committee 53/82 of 15 September 1982, implementing Arts. 22 and 26(a) of DL 50/82.
3. Resolution of the Central Bank 660/82 of 15 September 1982, implementing Art. 21 of DL 50/82.
4. Resolution of the State Finance Committee 54/82 of 15 September 1982, implementing Art. 18 of DL 50/82.
5. Resolution of the Chamber of Commerce 6/82 of 15 September 1982, implementing Art. 10 of DL 50/82.

ZIMBABWE:

A Survey of its Tax System

By D.G. Murphy *

Current taxes are the sales tax, the income tax, the branch profits tax, the capital gains tax and the three withholding taxes. The latter are resident and non-resident shareholders' tax and non-residents' tax on interest and are hereinafter referred to as RST, NRST and NRTI respectively.

SALES TAX

The present rate of sales tax is generally 15% but is 18% in respect of specified goods as motor vehicles, office machines, air-conditioning units, house and office furniture, electrical goods, clocks, watches and cameras. Sales tax is levied on tangible movable property, the discounting of agreements for the sale of goods by finance agents, the hiring of goods and on amounts payable in Zimbabwe for accommodation, travel by air, sea, road and rail, and telecommunication services.

Sales between non-traders are not - but imports by them are - subject to the tax unless an auctioneer, motor dealer or finance agent is involved. Traders with an annual turnover of more than $ 20,000 per annum operate in a tax-exempt ring. This avoids the levy of the tax on trading stock purchased by manufacturers, wholesalers and retailers. They charge sales tax on disposals to the end consumer.

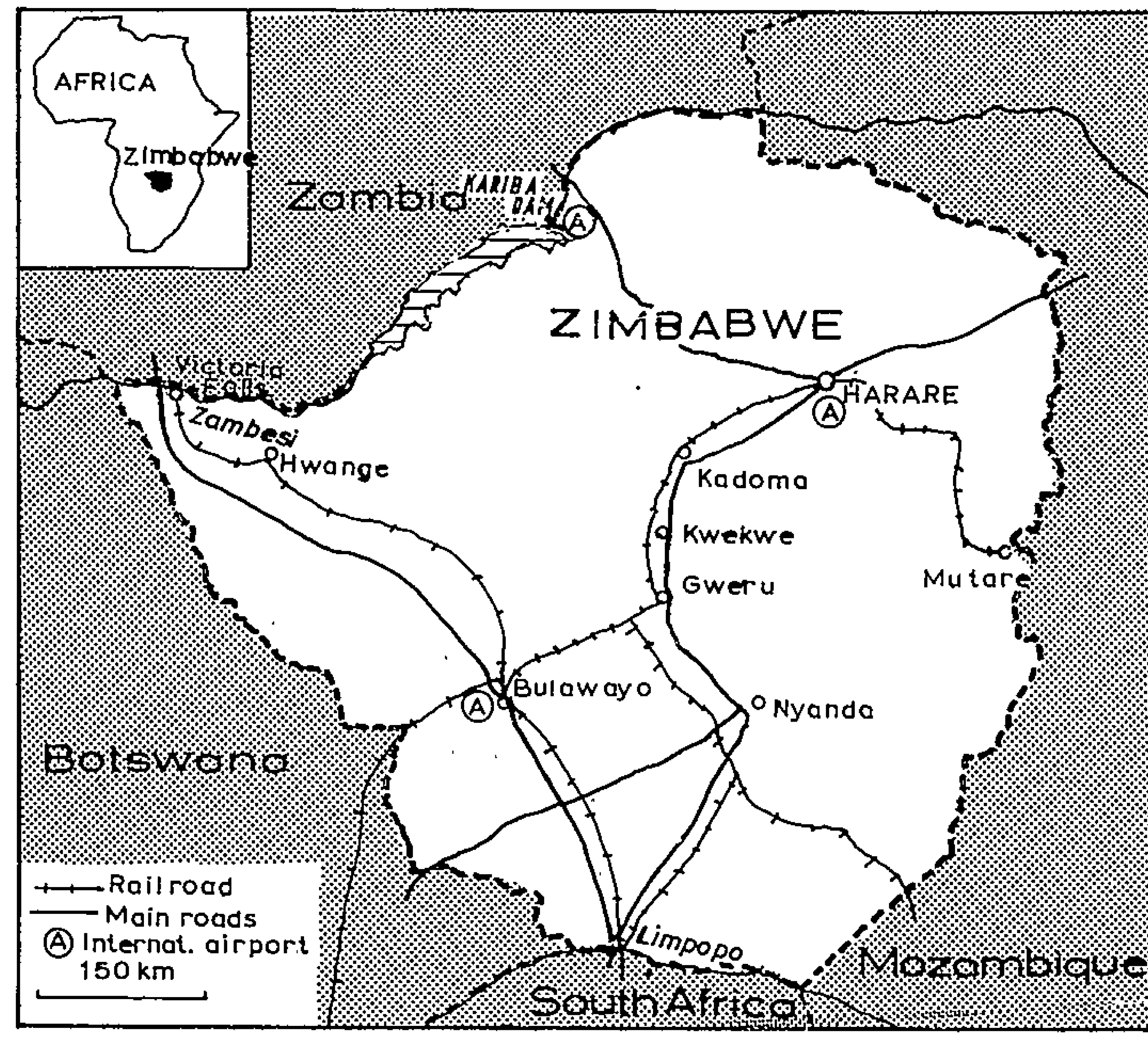
Monthly returns and payments are made to the tax authorities who employ a country-wide team of tax examiners.

INCOME TAX

1. General

Taxable income is gross income as reduced by exempt income and allowable deductions. Gross income is defined to include certain accruals of a capital nature and employee-benefits in kind. The taxable income of husband and wife is added together.

Liability is directed mainly at taxable income from a source within Zimbabwe but residents are also taxed on foreign interest, dividends and, if earned during a temporary absence, remuneration. Foreign dividends are charged at a flat rate of 20%. Income from a source within Zimbabwe includes amounts arising from the use in Zimbabwe of films, patents, designs, trade marks, etc., including amounts for know-how connected therewith.



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Whether an amount is actually remitted to Zimbabwe or not and where payment is made are not factors which have any bearing in relation to liability for Zimbabwean income tax.

A manufacturer, miner, producer or grower of goods in Zimbabwe is subject to income tax no matter where the goods are sold.

Dividends from local companies and interest from the local Post Office are exempt. In addition non-residents, including companies, who do not carry on business in Zimbabwe are also exempt on interest from loans to the state, local authorities, statutory corporations and miners.

The capital (depreciation) allowances comprise either a 100% special initial allowance (SIA) or a combination of wear and tear and scrapping allowances. The SIA is optional but is not granted on immovable assets merely purchased rather than constructed. (Legislation was enacted in 1981 to reduce the SIA from 100% to 30% for the 1982/83 tax year.)

However in the Budget announced in the House of Assembly on 29 July 1982 amending legislation was tabled to retain the 100% write-off.[1] Capital expenditure on mining assets may be written off in full or over the life of the mine and whilst no deduction is granted for the cost of mineral rights per se, a depletion allowance of 5% of sales goes to reduce taxable profits or to increase asessed losses. An incentive in the form of a non-depreciatory allowance of 15% of cost is granted on certain assets used in industrial and commercial operations in growth-point areas.

Assessed losses can be accumulated and are carried forward for deduction against all future taxable income.

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* Lecturer in taxation, University of Z[illegible]abwe, and tax consultant to Peat, Marwick, Mitchell & Co.

1. The Budget was enacted on 3 December 1982 as Finance Act 1982 (Act No. 30 of 1982).

Employees pay tax on their remuneration under the PAYE system. Other taxpayers are given fixed annual payment dates (APDs). For 1981/82 tax the first date is in the months August to December 1982 and the second date is four mounths later in the period December to April 1983. Different taxpayers have varying APDs which give a steady flow of revenue to the State throughout the year. The 1982 Budget proposals are to retain the two APDs previously fixed but to add 31 May 1983 for all taxpayers concerned. In this way 1982/83 tax will be payable in three equal instalments, the first falling due on 31 May 1983.

The statutory tax year is from 1 April to 31 March. Traders and companies may substitute an accounting year ending on a date other than 31 March provided approval is granted by the tax authorities. Approval is seldom, if ever, withheld.

Returns of income are made annually by taxpayers. They subsequently receive notices of assessment detailing the calculation of their liability.

All taxpayers have a legal right to object to an assessment and can pursue the matter by appeal to the courts.

2. Companies

The whole of a company's taxable income is charged with income tax at the rate laid down. Whilst abatements are granted to other taxpayers, none is granted to companies.

If a company is ordinarily resident in Zimbabwe and has income by way of foreign dividends, these are taxed at a flat rate of 20%.

All other taxable income is charged at 45% with an additional surcharge, currently 15%, giving an effective rate of 51.75%.

Group taxation is not available. Each and every company is charged as a separate taxpayer. However, companies under the same control can inter-transfer assets subject to the capital allowances at the tax written-down values provided the transfers are made in pursuance of a scheme of reconstruction, merger or other similar business operation.

3. Foreign companies

Reference has already been made under (1) above to the source of taxable income for Zimbabwean income tax purposes and to exemptions open to non-residents.

In general terms, the usual distinction between "trading with" and "trading in" is recognised and foreign enterprises which merely trade with Zimbabwe do not attract tax on their operations. However, mention must be made of one specific provision of the tax legislation. This renders a contract for the sale of goods subject to Zimbabwean tax if the contract is made in Zimbabwe.

Foreign companies are subject to income tax and surcharge on their Zimbabwean taxable income. They are also subject to branch profits tax which is dealt with below.

4. Taxpayers other than companies

The full taxable income is charged to tax at the rates currently in force. In the case of foreign dividends accrued to a taxpayer who is ordinarily resident, these are taxed at a flat rate of 20%. The balance of taxable income is charged at the rates set out below. The total tax so calculated is reduced by the tax equivalent of the abatements. The reduced figure, but excluding the tax on foreign dividends, is subject to a surcharge which is 15% for 1981/82. For 1982/83 the Budget proposals are to increase the surcharge, in stages, on tax payable of more than $ 4,000 until it reaches 33⅓% on tax payable which exceeds $ 12,000.[2] These proposals are illustrated by the following table:

Basic tax payable $ – $	*Surcharge* $		$
0 – 4,000	15 %		
4,001 – 5,000	600 + 16	% of excess over	4,000
5,001 – 6,000	760 + 17	% of excess over	5,000
6,001 – 7,000	930 + 18	% of excess over	6,000
7,001 – 8,000	1,110 + 20	% of excess over	7,000
8,001 – 9,000	1,310 + 22	% of excess over	8,000
9,001 – 10,000	1,530 + 24	% of excess over	9,000
10,001 – 11,000	1,770 + 27	% of excess over	10,000
11,001 – 12,000	2,040 + 30	% of excess over	11,000
12,001 and over	2,340 + 33⅓%	of excess over	12,000

The rates of tax currently in force are separately laid down for married and other taxpayers.

Married taxpayers - the taxable income is charged in segments of $ 1,000 at increasing rates of tax. The first segment is charged at 10%. The rate increases by 2% for each successive segment up to 40% for the sixteenth thousand. Taxable income from $ 16,001 to $ 17,000 is charged at 42.5%. Taxable income over $ 17,000 is charged at 45%.

Other taxpayers - The first $ 1,000 is charged at 14%. The rate increases by 2% for each successive $ 1,000 up to 40% for the fourteenth. Taxable income from $ 14,001 to $ 15,000 is charged at 42.5%. Taxable income over $ 15,000 is charged at 45%.

This can be presented in table form as follows:

Taxable income $ – $	*Married taxpayers* $	*Other (single) taxpayers* $
0 – 1,000	10 %	14 %
1,001 – 2,000	100 + 12 %	140 + 16 %
2,001 – 3,000	220 + 14 %	300 + 18 %
3,001 – 4,000	360 + 16 %	480 + 20 %
4,001 – 5,000	520 + 18 %	680 + 22 %
5,001 – 6,000	700 + 20 %	900 + 24 %
6,001 – 7,000	900 + 22 %	1,140 + 26 %
7,001 – 8,000	1,120 + 24 %	1,400 + 28 %
8,001 – 9,000	1,360 + 26 %	1,680 + 30 %
9,001 – 10,000	1,620 + 28 %	1,980 + 32 %
10,001 – 11,000	1,900 + 30 %	2,300 + 34 %
11,001 – 12,000	2,200 + 32 %	2,640 + 36 %
12,001 – 13,000	2,520 + 34 %	3,000 + 38 %
13,001 – 14,000	2,860 + 36 %	3,380 + 40 %
14,001 – 15,000	3,220 + 38 %	3,780 + 42.5%
15,001 – 16,000	3,600 + 40 %	4,205 + 45 %
16,001 – 17,000	4,000 + 42.5%	4,655 + 45 %
17,001 and over	4,425 + 45 %	5,105 + 45 %

2. See note 1.

All rates of tax are of course subject to change. Any change is usually notified at the commencement of the statutory tax year.

The primary abatements are $ 3,000 (married) and $ 1,800 (single). The child abatement is $ 500 per child and other dependants receive an abatement of $ 120/ $ 400 each according to the amount of maintenance afforded. The primary, child and dependants abatements cannot exceed $ 6,000 (married) or $ 3,000 (single).

There are additional abatements for blind, disabled and low-income elderly persons and for payments of insurance premiums and medical expenses.

The abatements are not deducted from taxable income. The rates of tax are applied to the figure of allowable abatements and the resultant figure goes to reduce the tax on the taxable income.

For example, the tax on a single person's taxable income of $ 8,960 at the rates given above is $ 1,968. Assume an entitlement solely to the primary abatement of $ 1,800. The tax on $ 1,800 at the same rates is $ 268. The tax of $ 1,968 is reduced by the $ 268. This results in $ 1,700. The surcharge of 15% is applied. The tax payable is therefore $ 1,955.

The tax before application is further reduced if the taxpayer's wife has taxable income from a business and/or employment unconnected with her husband. This further reduction, known as the "married woman's earnings allowance", or MWEA, is calculated at the marginal rate(s) of income tax applicable to her first $ 300 of such taxable income or one sixth of such taxable income with a maximum of $ 1,800. The maximum reduction for the MWEA is therefore $ 810, being 45% of $ 1,800.

5. Non-resident individuals

Non-residents are entitled to the primary, child, dependants, blind persons, and insurance abatements. For example, a non-resident married couple with two minor children could have a taxable income from Zimbabwean sources of up to $ 4,000 and pay no local income tax whatsoever.

Details of certain exempt income are given in (1) above.

6. Tax avoidance

The legislation contains specific provisions aimed at trafficking in assessed losses, parent-to-child transfers, imperfect alienations involving trusts, transfer-pricing, etc. In addition there is a general provision which negates the effect of transactions and schemes designed solely or mainly to avoid or postpone the liability for tax.

7. Double taxation relief

The legislation specifically provides relief against Zimbabwe income tax for foreign tax on taxable income from foreign sources. There is a double taxation agreement in force with the Republic of South Africa. It is expected that an agreement with the United Kingdom will be announced during 1982.[3] If a non-resident has interest which is subject to both income tax and NRTI, the income tax on such interest is reduced by the NRTI.

8. Branch profits tax

This tax can better be understood if regarded as an additional form of income tax. Only companies incorporated outside Zimbabwe are chargeable with the tax. The use of the term "branch profits" can be misleading. The tax is chargeable whether the foreign company has a branch in Zimbabwe or not and it is chargeable on taxable income, e.g. interest, from Zimbabwean sources. A locally incorporated subsidiary of a foreign company is not subject to the tax.

The effective rate of the tax is 8.4%. The total effective rate of income tax, surcharge and branch profits tax is therefore 60.15%.[4]

9. Capital gains tax

This tax was introduced only recently. Capital gains from the sale of specified assets on or after 1 August 1981 are charged at 30%. Only proceeds from sales which have a source within Zimbabwe are subject to the tax. Residence of the seller is irrelevant. The tax is charged on the overall net capital gain for the tax year. Losses can be accumulated and are carried forward for deduction against future capital gains. If the capital gain or loss for a year is less than $ 1,000 it is ignored. Amounts received or expended which are included for income tax purposes are excluded for the purposes of the capital gains tax.

Specified assets are immovable property, bonds capable of being sold in a share market or exchange, and quoted and unquoted shares. Assets in a deceased estate and bonds and stocks for loans to the state, local authorities and statutory corporations are not subject to the tax.

Disposals otherwise than by way of sale are treated as sales at fair market price. Assets expropriated are treated as having been sold. Recoveries, including insurance payments for damage or destruction, which exceed the cost of an asset are treated as proceeds from the sale of the asset.

Allowable deductions are the cost of the asset, selling expenses, bad debts and a notional allowance of 5% of cost for each and every year from the year in which the cost was incurred. However, the notional allowance is restricted to create only a no-profit, no-loss, situation and cannot create a loss in respect of a particulat asset or an overall loss for any single tax year.

Insurance and other recoveries which do not exceed the cost of an asset are set off to reduce the deductible cost of the asset and the 5% notional allowance is calculated on the reduced figure of cost for the year of recovery and the following years.

Companies under the same control can inter-transfer assets at the cost established for capital gains tax purposes provided the transfers are made in pursuance of a scheme of reconstruction, merger or other similar business operation.

Many of the provisions of the income tax legislation, e.g. assessments, appeals, tax avoidance, accounting years etc., apply for capital gains tax purposes.

3. When this article went to press the agreement had not been presented to Parliament for promulgation.

4. The interest is subject to income tax (45%), surcharge (15%) and BPT (8.4%), thus a total effective rate of 60.15%. The interest is also subject to NRTI but this is set off against any income tax and surcharge payable on the interest. See (7).

The Supplementary Income Tax on the Remittance of Dividends Abroad Revisited

By Ives Gandra da Silva Martins*

After the manuscript of my article on the Supplementary Income Tax[1] had been mailed to the publishers of the *Bulletin for International Fiscal Documentation,* the Secretary of Federal Taxation issued Ruling 49 of 14 August 1982 in which he accepted part of my views set forth in that article.

The text of this Ruling reads:

> The Secretary of Federal Taxation using his legal powers decides:
>
> I. The Supplementary Income Tax, based on Article 43 of Law 4,131 of 3 September 1962 amended by Article I of Law 4,390 of 29 August 1964, will be computed on the basis of the values of the foreign currency established in exchange agreements in relation to the benefits of values remitted, these values being equal to the rate of conversion on 31 December of the last year of the three-year period in which the excess amount of benefits remitted was paid.
>
> II. The Supplementary Income Tax will constitute a debt of the foreign recipient and must be deducted from the results or benefits, remitted in accordance with the law at the moment that they are distributed, credited, paid or used.

If we use the example set forth in my article,[2] the following example can be given:

	Capital	*Ranges*	*Excess value in the range rate*	*Tax*
FRR[3]		12 to 15%	30	12
Computation	1000	15 to 25%	100	50
		above 25%	230	138
Total			360	200

It is assumed that during the three years in question, the distributing company paid the normal 25% withholding tax on dividends on the distribution. This tax is computed in U.S. dollars converted into the Brazilian national currency, the cruzeiro, at the foreign exchange rate in force on the date of remittance.

However, for the Supplementary Income Tax, the exchange rate in force on 31 December of the pertinent three-year period will determine the rate at which the distribution must be converted into cruzeiros. Thus, if it is assumed that the Brazilian company distributed and remitted the income at an average rate of 150 cruzeiros per U.S. dollar, and if it is further assumed that on 31 December of the pertinent three-year period the rate of the cruzeiro is 200 per U.S. dollar, the Supplementary Income Tax must be paid in conformity with the latter rate. In the above example, this would mean that the tax is not U.S. \$200 × 150 = 30,000 cruzeiros, but U.S. \$200 × 200 = 40,000 cruzeiros.

The second section of the Ruling establishes that the Supplementary Income Tax due may be deducted from its taxable base. The Brazilian tax authorities had previously ruled that this tax should be deemed part of the remittance made.[4]

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1. "Brazil: The Supplementary Income Tax on the Remittance of Dividends Abroad – Legal Nature and Computation", in 36 *Bulletin for International Fiscal Documentation* 8-9 (1982) at 395.
2. Id., 401.
3. Id., 399.
4. Id., 399.

TAXATION AND INVESTMENT IN JORDAN

By Mazen K. Dajani *

LOCATION AND AREA

The Hashemite Kingdom of Jordan, which is situated in the northwest of the Arabian Peninsula, covers 37,138 square miles and is bordered by Syria on the north, Iraq on the northeast and Saudi Arabia on the southeast.

A good deal of the area is desert or semi-desert terrain, but a notable exception is the fertile irrigated land in the rift valley on both sides of the Jordan river. More fertile land exists in the highlands of the West Bank and those of the East Bank which stretch as far east as the historic Hijaz railway.

The Dead Sea (which is 1,286 feet below sea level) lies to the south of the River Jordan and forms a continuation of the rift valley, which stretches further south to Aqaba on the Red Sea.

INVESTMENT FACTORS

Although endowed with few natural resources apart from phosphate and potash, Jordan has a vibrant economy and is experiencing remarkable growth, spurred by successive development plans and aided with funds from oil-rich Arab countries and international agencies.

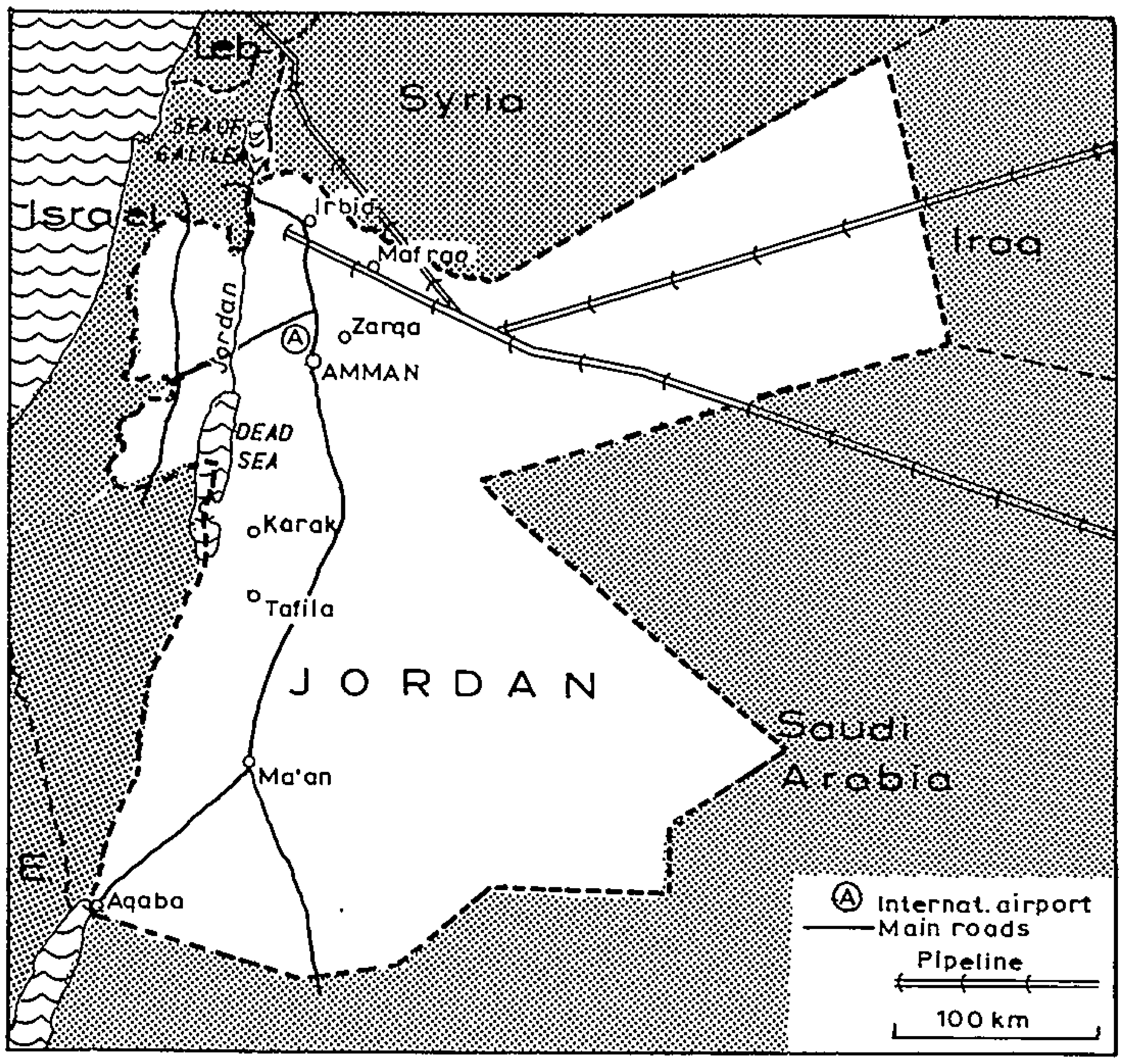
Government has as a priority the creation of a climate favourable for investment, and has itself invested heavily in a number of development projects. Through the enactment of laws that grant tax, customs duty and other exemptions, it is increasingly seeking to encourage domestic and foreign capital to invest in the country, and especially in the fields of industry and tourism.

Foreign firms face no restrictions when participating in Government public tenders and bids where international offers are invited, or when undertaking scientific and technical studies for the Government; in many such cases tax exemptions have been granted.

Presently, a number of free zones are being established in Aqaba and elsewhere in order to promote industry, trade and transit trade, and for this purpose the law grants a number of tax and customs duty concessions as well as many other exemptions.

Furthermore, industrial estates are being established in order to provide facilities and services for industrial units which when established or relocated therein would benefit from certain tax exemptions.

The law further encourages international companies to set up regional (offshore) offices in Jordan by providing



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tax and customs duty exemptions as well as free movement of foreign currencies.

There are restrictions on the involvement of foreigners in trade, where prior approval of the prime minister is required, and, in general, trade, representation and agency work are the domain of nationals. However, citizens of Arab countries are allowed to acquire shares of Jordanian companies traded on the Amman exchange market, provided the maximum number of shares so held does not exceed 49% of the capital of any company.

TAXATION

Taxes, it can be said, are not part of the country's heritage, except for the Zakat, a religious tax which is one of the 5 basic tenets of Islam; and even in this instance, compliance is a matter very much left to the discretion of the individual.

Broadly, the tax scene in Jordan has been characterized by jurisdiction lacking in its provisions, and by an administration lacking in competence. In an attempt to reform the situation Government recently came up with a new law, dismissed the majority of tax officers and recruited new staff instead.

It was, indeed, after lengthy (though by no means exhaustive) deliberations that Income Tax Law No. 34 was issued on 21 August 1982.

Some of the features of this law may be stated as follows:

1. The new law substantially mitigates the tax burden on individuals and on small profits, and by so doing appeals to those who have not been paying their tax bills to come within the ambit of the law and to comply.

* Saba & Co., Amman, Jordan.

2. By exempting farming activities altogether while reducing the tax rates on industry, health and education, Government is providing incentives for further investment in these fields.
3. Whatever the field of activity, the public shareholding company is more favourably treated than others. This reflects the commitment of Government to wide participation in the ownership of capital, notwithstanding the fact that Government itself is a major shareholder in a great number of projects.
4. Basically the new law is territorial in its concept, in that almost all income from sources outside the country is exempt from tax. Some sources inside the country are also exempt. Furthermore there is no capital gains tax except on real estate and, even then, it is limited in scope. As we shall see later, Jordan is in some respects a tax haven.
5. It is noted that by taxing companies on a graduated scale as individuals, it becomes advantageous to form a number of private shareholding companies to replace a partnership, since by so doing the same profits will be divided over the new entities and each entity will then be separately taxed. This would be a lucrative proposition in view of the fact that for companies profits are only taxed once at source. Similarly, it would be advantageous to fragment an existing company into a number of companies, each enjoying the benefit of the graduated tax.

TAX STRUCTURE AND RATES

For companies as well as individuals, tax is graduated, with the maximum rate varying in accordance with the legal form and nature of activity.

The schedule of tax rates applicable to companies and individuals as of 1 January 1982 is as follows:

	JD			JD	
First	1,000	5%	Next	4,000	35%
Next	1,000	10%	Next	4,000	38%
Next	2,000	15%	Next	5,000	40%
Next	2,000	20%	Next	5,000	45%
Next	3,000	25%	Next	6,000	50%
Next	3,000	30%	Over	36,000	55%

For individuals the maximum tax rate applicable is 45% in addition to a social service tax of 10% of the tax due.

The maximum rates for companies are as follows:

	Legal form	
	Public shareholding co.	*Private shareholding co.*
	Rate %	*Rate %*
1. Banking, finance, insurance, exchange and brokerage	50	55
2. Industry, health and education	35	38
3. Other	38	40

Non-resident partnerships are also taxed at a maximum rate of 40%.

Foreign shareholding (joint stock) companies are not mentioned in the law, but have been taxed so far at 40% and we can assume that this rate is still the maximum rate.

There is further a withholding income tax imposed at the rate of 10% on interest paid when such interest is not exempt from tax.

TAXABLE INCOME

All income arising within the country or realized therefrom is subject to tax, unless explicitly excluded by virtue of the new tax law or any other law. A number of sources are specifically mentioned, such as "gains arising from any contract within the Kingdom such as profits from contracting, tenders, agency commissions, representation agreement. . . and the like whether their source is from within the Kingdom or from outside". Also specifically mentioned are "gains arising from any commitments and income from salaries and fees for consultancy, know how, arbitration and the like".

Contracts for the supply of materials from outside the country are not taxable, although it is advisable in the case of contracts involving both supply and installation to have amounts for each clearly separated. The matter is not as clear, however, when considering contracts for services where all or part of a contract is to be performed outside the country. A good deal depends on the provisions of the contract.

In one case where 90% of an engineering consultancy contract was performed outside the country the court ruled that all of the contract was taxable. In cases like this, corresponding costs incurred outside the country would be deductible.

Another matter not referred to in the law or regulations is the treatment of long term contracts and whether the completed contract method is acceptable. The previous law was also not clear on these issues and it was implemented in an arbitrary manner, so that interpretation and practice varied from one tax officer to the other. It must be said here that although in many respects the new law is an improvement on the old, it is too brief and far from encompassing like its predecessor. In all it is made up of 54 articles. Apart from the law itself, instructions and regulations for its implementation are concise and do not fill in the gaps. Furthermore tax literature including court decisions and precedents is scanty and helpful only to a limited extent.

ALLOWABLE DEDUCTIONS

The new law allows "expenses wholly and exclusively incurred to produce income".

This includes interest, rent, salaries and wages on which payroll tax has been settled, social security contributions, termination pay (but not provision), bad debts, repairs and maintenance, depreciation of industrial buildings and of equipment, establishment expenses, head office charges (but not to exceed ½% to 1% of gross revenue or 5,000 JD annually, whichever is lower), and training expenses (to the same extent as entertainment expenses unless training is the responsibility of the head office or of suppliers).

Losses may be carried forward to a maximum of 6 years and in each of these 6 years may be offset against half the profits only. Depreciation charges, however, may be carried forward and applied against future profits until relieved, without any limit.

Disallowable expenses include capital expenditure, capital losses, provisions and taxes.

ACCOUNTING AND REPORTING REQUIREMENTS

The usual books of account are mentioned in the implementing regulations, and in practice these books need not be in bound form. Books of account as well as cards have to be stamped by the Companies Division at the Ministry of Industry and Trade.

The Companies Law makes it mandatory for all joint stock companies, whether national or foreign, to submit audited accounts, while the Tax Law stipulates that financial statements are to be submitted and the tax settled by the end of April for those companies whose fiscal year is the same as the calendar year. Although companies may fix their own fiscal year, for some unknown wisdom the Tax Law favours those taxpayers who follow the calendar year, by offering them reductions in their tax liability equivalent to 6% of the tax declared if tax declared is settled in January, 4% if settled in February and 2% if settled in March.

In contrast, those taxpayers who adopt a different fiscal year have only 90 days to submit financial statements and settle the tax declared, with no reductions offered.

To file tax returns a taxpayer has to fill in a prescribed form and have it submitted or mailed to the Tax Department within the periods mentioned above. In practice it is normal to include a copy of the audited financial statements, as it is usually asked for.

Neither the Tax Law nor the Companies Law mentions joint ventures and consortia. For tax purposes, however, each participant in a joint venture is separately responsible for his taxes and should independently submit a tax return.

Once this return is submitted and the declared tax settled, it should be possible to obtain tax clearance certificates as and when needed.

The new Tax Law, in an attempt to emphasize self-assessment, provides that a taxpayer's return is to be considered approved by the tax authorities if the taxpayer is not notified otherwise within a period of one year from receipt of his return. However the Minister of Finance or any officer delegated by him may within a period of 4 years from the end of the fiscal year reconsider and revise any decision taken by an assessing officer with regard to tax returns. Should the tax authorities exercise their right in not accepting the tax return submitted by a taxpayer they will then issue an adjusted assessment. If in turn the taxpayer objects to this assessment, this would give rise to an appeal to be lodged with the Tax Appeal Court. The appeal should be accompanied by a receipt showing that the taxpayer has settled that amount of tax admitted by him in his declaration. In cases where the tax imposed exceeds 1,000 JD decisions of the Court are subject to further appeal.

To minimise problems and adopt proper tax policies it is essential to keep proper books and records, follow an intelligible classification of accounts and avoid all ambiguities. Expenses incurred outside the country should be minimised as far as possible since they are likely to be either disallowed or treated as part of head office charges. The auditor can indeed help by being involved when the tax officer comes to review the books and prepare his assessment. Through his presence on the spot at this early stage the auditor can prevent such misconceptions and misinterpretations as are likely to be formed in the mind of the assessing officer.

If appeal to the Court is to be made, the taxpayer will then have to seek the assistance of the legal profession. In the appeal stage coordination with the auditor is also desirable and advantageous, since issues of an accounting nature are likely to arise.

ACCOUNTING PRINCIPLES AND AUDIT

In Jordan, there are no generally accepted accounting principles, with accounting firms usually advocating principles applied elsewhere. There are, moreover, very few requirements that deal with the actual contents or form of the accounts. There is, however, a tendency for more disclosure and clarity in the financial statements and the accompanying notes.

The Tax Law requires auditors to submit annually a list of their clients to the Tax Department, and further gives the tax authorities the right to take action against auditors in more than one way if they act in any manner prejudicial to the Law or to their profession.

OTHER TAXES

The Social Security Law which was promulgated in 1978 is gradually being applied to the private sector. Presently, it is mandatory for all establishments employing 20 persons or more, and applies to all employees and labourers without regard to the form of contract or to nationality. The employer contributes 10% while the employee contributes 5% of the monthly salary, to cover retirement benefits as well as occupational disease and work injuries. In future more benefits are to be added, especially medical insurance, which would entail increases in the contributions of either or both the employer and the employee. If the employee becomes unemployed or leaves the country he would be entitled to partial reimbursement under the scheme.

JORDAN AS A TAX HAVEN

In many ways Jordan offers tax advantages, tax holidays and exemptions which are very much characteristic of tax havens. Under the new Tax Law, we have seen that almost all income derived from sources outside the country is exempt. Bonds issued by Government and by corporations are exempt, and so is farming and related activities. For individuals, interest earned from finance institutions is also not subject to tax.

Furthermore the Tax Law gives the Government the right to exempt parties with which it enters into contracts from tax. This discretion has in fact been used in numerous cases, and especially with international contracting firms and consultants.

The Law of Registration of Foreign Companies which provides for the setting up of regional offices in Jordan exempts such offices from tax on income derived from outside the country, and further does not subject to tax the income of their non-Jordanian staff. Such regional offices are also given the right to maintain non-resident accounts with Jordanian banks in any currency with the freedom of transfer of funds to and from the country.

By virtue of the Encouragement of Investment Law, "approved" projects for investment in industry and tourism have tax concessions for periods of up to 9 years, depending on location and legal form. Customs duties are also waived on machinery imported, whether on setting up the project or for the purpose of expansion and improvement of facilities. Land may be allotted free of charge to such projects. Moreover the transfer of profits as well as the repatriation of capital are facilitated.

Also by virtue of a law creating the Industrial Estates Corporation in 1980, incentives are given to industries to be established or relocated in estates now being built, in the form of tax holidays for 2 years as well as exemption from real estate taxes.

Other incentives and concessions are also given to export-oriented industries set up within the free zone areas.

In order to qualify for licensing within a free zone area, industries should possess the attributes of being new to the country, adopt modern technology, use local raw materials or components, improve labour skills and reduce the dependence on imports.

If so licensed, industries enjoy the following exemptions and benefits:

1. Profits are exempted from tax for a period of 12 years.
2. Non-Jordanian employees are exempt from payroll tax and social service tax.
3. Goods imported into such zones from outside Jordan or exported therefrom to a foreign market are exempt from customs duties, import fees and any other taxes or fees, except those representing services and wages.
4. Buildings constructed therein are exempt from licensing fees as well as from taxes on real estate.
5. Capital invested may be repatriated and profits thereon transferred according to prevailing laws and regulations.

Presently, free zones are being established in Aqaba on the Red Sea and in the north along the border with Syria.

Corporate Tax Laws as Instruments of Economic Policy: Some Finnish Experiences

by Edward Andersson *

Before discussing the subject proper I will state some basic facts about the Finnish system of corporate income taxation. Finland has a normal flat-rate system of corporate income tax, the rate being 43% for the State and about 16% for the municipalities. As corporations are entitled to certain deductions for distributed dividends, in order to alleviate double taxation at the corporate and shareholder level, the tax rate is, in reality, somewhat lower than 59% (= 43% + 16%), probably 50% on an average. However, enterprises have considerable possibilities for adjusting their financial results and thus taxable income; the most important of these are (i) the right to undervalue the inventories by 50% of the cost price and (ii) the 30% degressive depreciation[1] on machinery. These measures lead to the forming of reserves in good years, when only part of the profit made is shown. In bad years, the inventory reserves may be dissolved and a result may be shown that is better than the one the enterprise has actually achieved. Even if these possibilities of forming reserves which are acceptable tax-wise are an important advantage to enterprises, they do not result in any definitive loss of tax yield for the Treasury. But in their choice between showing profit and paying taxes thereon, on the one hand, and investing and postponing the tax liability of the reserves to a later fiscal year, on the other, enterprises tend to choose the latter alternative.

Low yield of corporate income tax

This is one reason why the yield of corporate income tax is rather low in Finland. Of the total yield of income taxation, corporate income tax represents only 7% and of the total tax revenue of Finland only 4%. The main reason for the very low yield of corporate income taxes is, however, not the above-mentioned possibility of adjusting the taxable results and postponing payment of tax, but, rather, the poor general profitability of the corporate sector. I know that in the United States corporate income tax represents a much higher percentage of federal tax receipts (about 11-12%) and I presume that American corporations, with their very large domestic markets and – in many fields – their very strong positions in the world economy, have, on the whole, far better profitability than Finnish companies or those of most other small countries. The latter cannot rely on strong domestic markets but have to compete in international trade on the terms that are laid down by the large multinational enterprises.

The small tax yield of Finnish corporate income taxation has even given rise to recent discussion on whether corporate income tax could be totally abolished and replaced by a less complicated system of collecting the same total amount of tax revenue. In my opinion, this discussion is a purely academic and unrealistic one: a small country which is largely dependent on its foreign trade, which hosts numerous subsidiaries of foreign companies and which has concluded a great number of double taxation treaties cannot adopt a corporate tax system that would be fundamentally different from the systems used in the rest of the world. On the other hand, it may be said that the small yield of corporate tax makes it possible to start some experiments in the field of corporate tax legislation, since the economic risk for the public purse is fairly small. I should also mention that the Finnish budget authorities do not even try to calculate how much less tax revenue for the State certain tax concessions would result in. I know that in this respect the U.S. budget authorities have far greater obligations and ambitions, but I cannot perceive how these calculations could be made with even a slight degree of exactitude in a country like Finland, where the tax legislation gives enterprises themselves considerable possibilities for determining the amount of their taxable income. At least one can say that it has been fairly easy in Finland to enact such elements in the corporate tax legislation which do not aim at increasing the tax yield but which could rather be characterized as measures of economic policy. The ruling philosophy in taxation has been that the main fiscal purpose of the corporate sector is to provide employment for individual people, so that they can earn income and pay income taxes as well as consume commodities and, thereby, give the Treasury tax revenue in the form of indirect taxes.

Heavy taxation of individuals

The fact that the tax yield of the corporate sector is small in Finland has the consequence that, instead, the income taxation of individuals must be severe in order for the entire income taxation to produce a fair yield. Thus, taxation of individual income is severe in Finland, as it is in the whole of Scandinavia. Although this is not the subject of this article, some information might yet be given on personal income taxes. In Finland, an individual has to pay municipal income tax (and a number of accessory taxes) at a flat rate of approximately 19% and State income tax on a progressive scale, the highest percentage being 51% (above 342,000 FIM = $65,000). A skilled worker earns approximately $10,000 a year and he pays 28% income tax, but the marginal tax rate in his top brac-

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1. I.e. declining balance depreciation.

ket is approximately 48%. If a professor has no extra income, he earns about $23,000 a year, and his average rate is 41%, while his marginal rate is about 57%. These taxes are thus considerably higher than those in the United States. In addition, we have a net property (net wealth) tax, levied on every individual who has net wealth worth over $45,000. This tax, too, is progressive with a maximum rate of 1.7%, from and above $180,000. The net wealth tax on $180,000 is $1,800, while the tax on net wealth of $1.8 million is approximately $27,000 (= 1.5%). Fortunes worth millions of dollars are, however, rare in Finland. Net wealth tax is not deductible in income taxation, but has to be paid out of income after tax. Although not all kinds of property are assessed at their full market value, the net property tax is a very heavy burden on certain taxpayers, especially the owners of small and medium-sized family enterprises. The cumulative effect of both income tax and net property tax has also made it necessary to enact a provision according to which *the total sum* of these taxes may not exceed 80% of the taxpayer's income.

The investment reserve system

As I already mentioned, the Finnish rules on depreciation allowances – like the corresponding rules in many other countries – give enterprises certain possibilities to form reserves and to adjust their taxable income. These rules are mainly favorable to profitable enterprises. In general, we can say that favorable depreciation allowance rules encourage investment activities, which in turn means greater economic activity and less unemployment in society. Under Finnish tax law, depreciation on an asset may not be commenced before the asset is taken into use. Favorable depreciation rules may, however, lead enterprises to invest during a boom period, when inflationary tendencies are strong and investment costs usually high because of strong economic activity in society. But it would be better for the public economy if enterprises invested during the next depression period following the boom. This is the background of the *system of investment reserves* that I shall now describe.

If one wants enterprises to postpone their investments and not to invest during the boom period when they have usually earned the money required for the investment, one has to grant them certain favors. As the investment is often made in order to give the enterprise the advantage of taking depreciation deductions and thus avoid paying taxes on all the profits earned, it is natural to grant the enterprise the favor of making a special deduction and of not having to pay tax on the profits, though it does not use the profits for investment and thus cannot take the normal deductions. We call this special deduction an investment reserve deduction. The maximum of the deduction is normally 50% of the profit of the enterprise, calculated on the basis of its profit and loss account. The condition for the right to use the investment reserve deduction is that in its books the enterprise creates an investment reserve for investments to be made in later years equal to the amount deducted; these investments need not be specified. But the economic purpose of the investment reserve system, viz., to mitigate economic fluctuations, would not be realized if the income whose taxation was deferred were at the free disposal of the enterprises. Therefore an enterprise which creates an investment reserve in its books and takes the corresponding deduction from income has to deposit with the National Bank an amount equal to 50% of the amount deducted, i.e. roughly the amount of the tax that would have been due. The enterprise has the right to withdraw this deposit when it has obtained permission to use the reserve for an investment.

Enterprises may not themselves freely decide when to use the investment reserve for an investment; society and the Treasury also want to have their say in the decision. Firstly, the Government makes a general decision that existing investment reserves may be used for investments during a certain period of time (the depression period). Secondly, the fiscal authorities must grant permission to withdraw the deposit in individual cases. The permission cannot, however, be denied if the planned investment meets the conditions stipulated in the law. The investment must then be carried out wholly or partly during the prescribed period of time. According to the law, the government may even impose on enterprises the obligation to invest if they want to retain their investment reserve and not have it added to taxable income, but such obligations to invest have never been imposed in practice. Further, it is possible that a general permission to use the investment reserves is granted selectively only with regard to certain geographical areas of the country or to certain types of business. When five years have pased, the investment reserve may be used without the general permission of the Government, but the individual permission to withdraw the deposit must still be obtained and the investment must meet conditions stipulated in the law.

Example

If an enterprise uses an investment reserve of 400 for an investment costing 1,000, normal depreciation must be computed on 600 only, as 400 was already deducted in the year when the reserve was created.

This example shows that the investment reserve is a kind of advance depreciation deduction, which is not connected with a specific asset, but generally with the assets the enterprise may obtain in the coming years. The reserve may remain in the books for a very long time if the enterprise lacks suitable investment objects. Naturally, there must be penalty rules for cases when an enterprise does not invest at all or gets permission to withdraw the deposit but does not use the reserve for an investment specified in the permission.

It is not possible to calculate how significant the advantage generally is that the investment reserve system gives to enterprises. The figures would vary from enterprise to enterprise and even within one enterprise, depending on what investment and alternatives are available and to what extent financial results can be adjusted and for how many years the reserve may remain unused. An enterprise will get the greatest advantage if it can use the reserve for investments with a long normal depreciation period and if it can use it as soon as the year after the reserve was made. If the other available means of forming reserves are fairly good – which may often be the case in Finland – and if the State finds it important to promote the forming of investment reserves, special additional advantages may be attached to them. Thus, in Sweden, where the system of investment reserves was introduced as early as 1938, a special investment deduction in addition to depreciation deductions, so that more than 100% of investment cost may be deducted, is granted to the enterprise when the investment has been duly completed. This system has also been resorted to, to a certain extent, in Finland.

If one regards the investment reserve system as an instrument of fiscal policy, it is obvious that the larger the total amount of the reserve, the stronger an instrument it is. In Finland, at the beginning of the current depression, the total amount of these reserves was equal to some 4% of the State budget. If this amount will be used for investments, it would mean a considerable injection of investment expenditure to counteract the depression.

Ad hoc measures

The legislation regarding investment reserves is a permanent part of Finnish tax legislation. But the legislature has also resorted to temporary, ad hoc measures in order to induce enterprises to speed up their investment programs. These measures have usually included allowing enterprises to start depreciation from the time an order for an industrial investment was placed or an investment was commenced and afterwards to grant depreciation at will, without being restricted by the normal maximum depreciation percentages, provided the same depreciation deduction was taken in the books. As an example of such legislation I can mention a statute , enacted at the beginning of 1982. According to this law, enterprises which, during the period from 1 January 1982 to 31 December 1983, invest in industrial buildings and machinery to be used in the same buildings, are entitled to start taking depreciation allowances as soon as the construction work has begun and the machinery has been ordered. No conditions have been attached to these tax advantages other than that the investments meet certain legal conditions which clearly favor industrial activity and exclude merchant trading. This system is definitely more favorable than the system of investment reserves, but it is now and on previous occasions in force only for a short period of time. The question remains whether the Government will be able to observe the recession early enough and whether the recession can correctly be judged to be so deep that special measures are desirable. There is a risk that these tax measures will be put into force too late and that they will have no effect until the depression has passed. There is also the question whether enterprises in general have been able to prepare such complete investment plans that their realization can start as soon as Parliament has approved the pertinent Bill. It is possible that these temporary special depreciation rights will be used mainly by those enterprises which would have invested anyway during the short period prescribed in the temporary law. If this is the case, such temporary tax concessions will only have very little effect on the depression.

As I already mentioned, these temporary depreciation rules are mainly intended to favor building investments, while investments in machinery that are not to be used in these new buildings receive no privileged treatment. The reason for this is that the Finnish authorities have always paid special attention to the direct and indirect effects on employment of construction work during the time of construction, while machinery is often ordered from abroad and thus does not provide any employment during this period. This view is a correct, but not a very farsighted one. In the long run, building investments are rather to be considered fairly unproductive. Such an inefficient allocation of investments should probably not be favored by tax concessions. Many Finnish industrialists have told me that in the United States industrial buildings are looked upon rather as shells for the machinery and that their relative portion of the investment cost is far lower than in Finland. We must not, however, forget the demands that the Finnish winter climate puts on industrial buildings.

The two examples of Finnish tax legislation that I have so far given are clearly aimed at increasing investment activity during a period of depression. In principle, this aim is easy to reach, as the question is mainly how large are the tax concessions one is prepared to give enterprises and in what form. It may also be discussed whether it is at all appropriate to use tax measures or whether enterprises should be granted pure subsidies. Personally I am in favor of special depreciation concessions of the type used in Finland, because they are of no value at all if an enterprise cannot show a profit, and accordingly these rules favor profitable enterprises. This condition does not, on the other hand, apply to pure subsidy payments. Keeping in mind the future of both the enterprise itself and of the Treasury, it is, of course, important that investments favored by tax concessions should be economically as sound as possible. But it has to be admitted that favorable depreciation allowance rules may sometimes make an investment profitable even though it would not be profitable without the tax concessions.

Regional policy

For the reasons given above, these depreciation concessions may, however, not be effective enough from the point of view of regional policy. It must also be admitted that existing and new enterprises are in very different positions as to their opportunities of making use of these concessions. Enterprises that have been started only recently seldom have much use for opportunities of taking fast depreciation allowances, as their main problem is how to avoid losses during the difficult first years.

In the northern and eastern parts of Finland, there are large underdeveloped areas where unemployment is a permanent problem. In order to help create new industry and promote employment in these areas, the Finnish legislature has resorted to the same method of applying special depreciation rules for those persons who start new industrial enterprises or extend existing ones in these underdeveloped regions. New enterprises may also receive, either alternatively or cumulatively, large subsidies and favorable loans. It would be desirable if an official estimate were made regarding the effects of these regional tax concessions that have been in force, in one form or another, since 1958. But it would be nearly impossible to make such an estimate in a reliable manner, as nobody can tell to what extent the investment decisions of enterprises were influenced by the tax concessions and to what extent by other factors.

Penalty taxes

So far I have been talking about such measures of tax law as could be said to give taxpayers special favors in order to induce them to invest and thus to increase the economic activity of society. But is is also possible to think of legislative measures with the opposite aim, i.e. special penalty taxes to prevent enterprises from investing during a given economic cycle. Measures of this kind have been used in Finland, too. The Government has been of the opinion that the building industry tends to be overheated in certain parts of the country during certain economic cycles, with the result that the costs of construction are increased unreasonably. In order to give the Government possibilities to intervene in this development, Parliament has passed a bill that authorizes the Government (when it considers the building industry to be overheated) to impose a "penalty tax" of up to 40% of the costs of construction. This tax is in force for a limited period of time, for instance, for one year. The target of the penalty tax is "less desirable construction work", such as offices, shops, holiday houses and the like, while industrial buildings and dwelling houses are exempted from it.

During the last 10 years, this Act has been implemented for two periods, and the penalty tax has been applicable only in the southern parts of the country. A penalty tax of 40% is so high that it effectively prevents the construction of such buildings as are covered by the Act. The yield of the tax has therefore been very low, which was also the original intention. This fact need not, however, signify that such a tax is an appropriate measure. At least our experiences show that it is very difficult for the Government to decide when the construction business is so overheated that the implementation of the Act would be warranted. Usually the political decision is taken so late that the damage caused by overheating, which was meant to be avoided, has already occurred. Another disadvantage seems to be that during the period the penalty tax is in force a great demand for building investments is accumulated. This can easily lead to an artificial but harmful boom soon after the time when the penalty tax ceased to be in force. There is in Finland no unanimity on the necessity for such a construction penalty tax. The Act was approved at the demand of the Socialists as the result of a political compromise, in which the non-Socialists were able to have some other bill passed which was important to them. The Act is a kind of emergency legislation which always requires a special decision by the Government to come into force. It depends on the political composition of the Government whether a decision is made concerning the enforcement of the law and whether such a decision is made at the optimal time or too late. Of course, it would be good, for many reasons, if the construction industry showed a steady development without overheating. But nobody has proved beyond doubt that this Act is effective in this respect.

I want to stress that the system of penalty taxation just mentioned does not apply to other investments than those of building construction. Further, it is not particularly directed against investments made by enterprises; industrial buildings are not affected at all, while the tax may affect the construction of office and shop buildings, such as supermarkets. On the other hand, no efforts have been made in Finland to control other kinds of investment, such as machinery, by means of penalty taxes. One simple reason may be that the investment level in Finland has never been too high and that Finland is so newly industrialized that the volume of investment per person employed has never reached figures comparable to those of countries with a longer industrial tradition.

Conclusion

In this article I have dealt with different measures of tax legislation that have been used in Finland with the aim of attempting to level economic booms and depressions. Most of these measures have been positive in the sense that they have given enterprises certain tax favors, on the condition that they behave in the way the State desired. But I have also offered examples of negative measures in the form of penalties for such investment as have been considered less desirable at a certain period of time. For all those who are strongly in favor of free competition and who find it desirable to have as little public regulation of business as possible, the above-mentioned measures may not sound at all attractive. But I take it that the tax law measures of a positive character just described are far less uninviting than the measures which consist in levying penalty taxes on investments that are, as such, quite legal, normal and probably even useful. It is also my opinion that if the State undertakes to influence the business cycles, tax favors are a far less controversial method than penalty taxes. It seems to me that tax favors are in fact used, to a certain extent, in nearly all countries as a means to reach public goals other than that of collecting as much tax revenue as possible.

I would like to go a bit further and assume that every country has to admit that tax legislation is one of the most efficient tools available for directing economic policy. Why would a State refrain from using this tool? The most important question is rather *how* that tool is to be used.

Neutrality between different business branches and different taxpayers is a very important requirement. If the State adopts tax laws that are not neutral, it may have considerable influence on the relative working conditions of different branches and enterprises. The Finnish system of investment reserves, described above, seems to be fairly neutral, since the creation of a reserve depends on the profitability of the enterprise itself and the State does not have a considerable influence on the choice of investment objects, but only on the time of the investment.

But I have also given examples of tax advantages that are very clearly in conflict with the principle of geographical neutrality. The outspoken aim of these measures is to favor investments in certain areas of the country which have a high rate of unemployment and which are also underdeveloped in other respects and thus in need of help to bridge the gap with the other regions. Geographical neutrality has been set aside and the wish to improve regional balance is the main reason for such tax legislation. This starting point has been generally accepted and the political lobby has mainly concentrated on the drawing of geographical borders for the tax advantages, i.e. efforts have been made to enlarge the area qualifying for reliefs. But in other respects, even these tax advantages seem to be fairly neutral: any enterprise investing in industrial activities in the areas prescribed by the law is entitled to these tax advantages. In fact, one important purpose has been to make economically strong enterprises from the more industrialized parts of the country locate new industrial works in the underdeveloped areas. The legislature has hoped to guarantee permanent new employment by letting the investing enterprise cover the losses and extra costs of the first years of the new factory with profits derived from its other units.

Naturally, it is not my intention to advocate such measures of tax policy which may be good in my country but need not be practicable in another country with a different economic structure. It has only been my intention to tell you about certain innovations of tax policy that have been adopted in Finland and in the other Nordic Countries. In these countries, which have small domestic markets and thus are greatly dependent on international trade, it has seemed utterly important to try to level the economic fluctuations to the extent that this can be done with the help of internal measures. But some of the solutions used, especially the investment reserve system, might, in my opinion, be worth considering in other countries, too. As for the regional differences and the possibilities to reduce them by measures of tax policy, I assume that the problem exists in most countries. I am not well informed of whether and, if so, to what extent measures of tax policy have been used elsewhere in this respect. But most likely this is also a field where exchange of experiences across the borders might be useful.

Conference Diary

MARCH 1983

British Branch of I.F.A.: Tax aspects of interest (Tax workshop). London (United Kingdom), March 2 (English).

Management Centre Europe: Managing and developing foreign subsidiaries (including: tax in international operations). Brussels (Belgium), March 28-30 (English).

APRIL 1983

The Taxation Institute of Australia: Sixth National Convention (including: the role of the High Court in interpreting tax statutes; taxation of technology; tax shelters and planning for the '80s). Melbourne (Australia), April 10-15 (English).

Management Centre Europe: International tax conference (including: intra-group services; relationships with the national Fisc in country of operation; changes in the tax climate). Brussels (Belgium), April 13-15 (English)

Seminar Services S.A.: International Tax Planning. Amsterdam (the Netherlands), April 11-13 (English).

Institut für Finanzwirtschaft und Finanzrecht: Internationales Steuerrecht und Steuerplanung (International tax law and tax planning) (Seminar). St. Gallen (Switzerland), April 11-14 (German).

OCTOBER 1983

British Branch I.F.A.: U.S./U.K. Seminar. London (United Kingdom), October 7 (English).

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen, Varnbüelstrasse 19, 9000 St. Gallen (Switzerland).

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

Seminar Services S.A.: 1-passage Perdonnet, CH-1005 Lausanne (Switzerland).

The Taxation Institute of Australia: 113 Swanson Street, Melbourne VIC. 3000 (Australia).

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Books

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of this issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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(B. 13.129)

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General information for interested businessmen wanting to know about investing in Malawi. Taxation aspects are included.
(B. 13.126)

Tunisia

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Aspects juridiques et fiscaux d'une implantation en Tunisie.
Paris, Editions Eurafricaines (2, Rue Saint-Lambert, 75015 Paris, France), 1982. 144 pp.
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Zambia

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Lusaka, Coopers & Lybrand (P.O. Box 30885, Lusaka, Zambia), 1981. 8 pp.
Commentary on the Income Tax (Amendment) Act 1981.
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Lausanne, Business International S.A., 1982. 155 pp.
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AMERICA

Canada

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A guide to the incorporation of companies in Canada and Canadian taxes.
XXXVI Congress Montreal, Canada.
Toronto, Canadian Imperial Bank of Commerce (Commerce Court, Toronto, Ontario M5L 1A2, Canada), 1982. 88 pp.
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McQUILLAN, Peter E; COCHRANE, E. Cal
Understanding the taxation of partnerships.
Don Mills, CCH Canadiaan Ltd., 1982. 158 pp.
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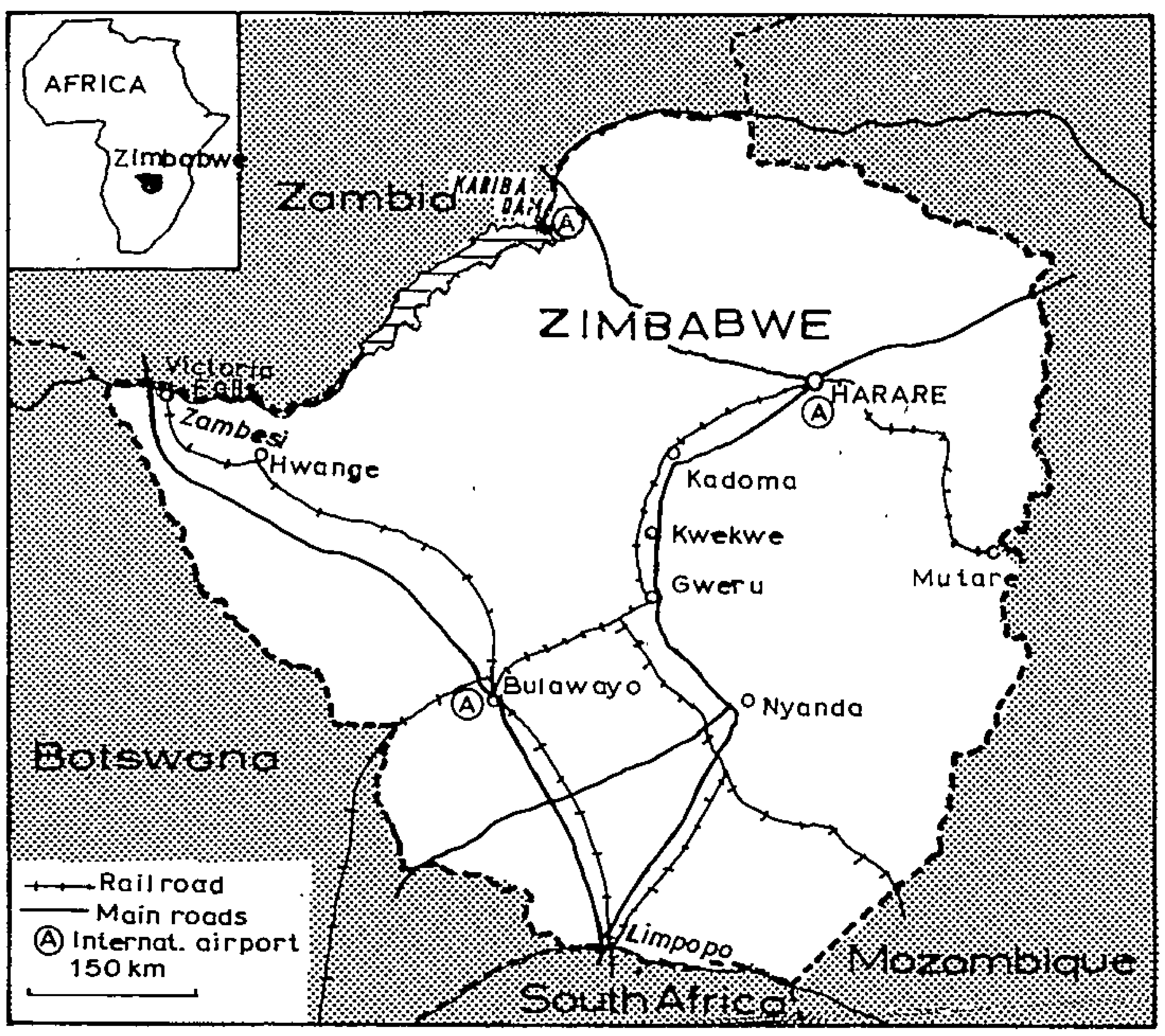
The Experience of Zimbabwe with a Retail Sales Tax

By John F. Due



VAN PELT, AMSTERDAM

I. INTRODUCTION

The retail form of sales tax, dominant in the tax structures of the states of the United States and the provinces of Canada, has been used in only a few other countries, and rarely in developing countries. It has generally been concluded by government commissions, international agencies, and public finance economists that the retail form of sales tax is unsuitable for LDCs. Thus the experience of Zimbabwe with the retail tax over nearly 20 years is of particular interest.

In 1963 the Federation of Rhodesia and Nyasaland broke up, leaving Southern Rhodesia with seriously inadequate revenues as it took over many functions of the Federation yet lacked the ability of the latter to benefit from the copper revenues of Northern Rhodesia (thenceforth Zambia). Accordingly, the government of Rhodesia looked for new sources and selected the retail form of sales tax, which it imposed in October 1963. Initially at 5%, the rate was increased to 7.5 and then to 10 where it remained down to 1976, as subsequently noted. Currently the tax yields 26% of total tax revenue, an unusually high figure for a sales tax in any developing country. It is second only to the income tax. Table 1 shows the relative reliance on the major tax sources in recent years, Table 2, the figures from 1965. Customs have traditionally played a minor role in revenues, in the last decade import controls being used for foreign exchange restriction instead of customs. A surcharge on all (with few exceptions) imports, now 15%, has recently increased the importance of this source.

A brief summary of the economy is desirable as a background.[1] As of January 1982, the population is estimated to be 7.7 million, of which 96% are black, 3% white (240,000) and 0.5% Asian and Coloured. The population growth rate is estimated to be between 3 and 3.6%. About 70% of the population is directly dependent on agriculture, a large part of the marketed output provided by a few thousand commercial (mainly white) farmers. The country is more than self-sufficient in food. Substantial tobacco is exported. The manufacturing sector has grown very rapidly, and most of the final products consumed in the country are produced locally, probably more so than in any other tropical African country. Mining is also important, though relatively much less so than in neighboring Zambia. About 20% of the population is urban, 45% of this portion in Harare (formerly Salisbury), 26% in Bulawayo; with per capita income (1982) estimated to be Z$ 420 (equivalent to US$ 550[2]), the country is in the upper ranges of the LDCs.

II. THE STRUCTURE OF THE SALES TAX

The sales tax is a single stage retail tax, applying to the final sale of commodities, rental of commodities, and specified services, and to the importation of goods by final users or consumers. The coverage is broad compared to the sales taxes of most developing countries.

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The author is greatly indebted to officials of the Zimbabwe Department of Taxes, Zimbabwe Customs and Excise, and the Associated Chambers of Commerce of Zimbabwe, and members of the faculty of the University of Zimbabwe for their assistance. The University of Illinois Research Board provided financial assistance.

1. Based primarily on Zimbabwe, Ministry of Economic Planning and Development, *Annual Economic Review of Zimbabwe,* Harare, August 1981, and Zimbabwe, Central Statistical Office, *Monthly Digest of Statistics,* August 1982.
2. Converted at the current exchange rate (October 1982). A free market rate is estimated to be closer to a 1 to 1 ratio.

TABLE 1

Major tax revenues of Zimbabwe 1979/80 – 1982/83
(Z$ 1,000)

	1979/80	1980/81	1981/82[a]	1982/83[b]
Sales tax	171,141	180,427	280,748	440,000
Customs duties	22,195	59,627	140,125	244,000
Excises	42,309	83,040	130,109	161,000
Total, goods and services[c]	237,974	327,988	556,083	851,050
Income and profits taxes	315,864	437,452	664,221	859,500
Stamp duties	5,576	9,888	10,541	12,600
Estate duty	2,326	2,359	2,246	4,500
Total tax revenues[c]	561,744	777,730	1,233,097	1,727,655

a. Provisional.
b. Budget estimate.
c. Including minor miscellaneous items.

Source: Zimbabwe, Central Statistical Office, *Monthly Digest of Statistics,* August 1982.

Percentage distribution of tax revenues

	1979/80	1980/81	1981/82	1982/83
Sales tax	30.5	23.2	22.8	25.5
Customs duties	4.0	7.7	11.4	14.1
Excises	7.5	10.7	10.6	9.3
Total, goods and services[a]	42.4	42.2	45.1	49.3
Income and profits taxes	56.2	56.2	53.8	49.7
Stamp duties	1.0	1.3	.9	.7
Estate duty	.4	.3	.2	.3
Total tax revenues	100.0	100.0	100.0	100.0

a. Including miscellaneous.

Exemptions

The exemptions are relatively limited in scope:

(1) A few basic foods, which make up most of the diet of the low income groups: bread; milk in all forms; maize; maize meal (mealie meal, the staple food in much of central Africa); uncooked meat, poultry, and fish; cooking oil; tea.[3] All other food is taxable.
(2) Prescription medicines.
(3) Farm feed, seed, fertilizer, livestock, pesticides and related items; some fencing and irrigation equipment. Farm machinery and other farm items are taxable (refund of tax was once allowed on farm machinery).
(4) Coal and coke purchased in amounts of 3 tons and over; cement in purchases of one ton and over.
(5) Petroleum products (subject to excises).
(6) Railroad track items and rolling stock; commercial aircraft.
(7) A few items used in mining; gold bullion.

TABLE 2

Sales tax revenue as percentage of total tax revenue Zimbabwe, 1965, 1968, 1971-1980

Calendar year	Sales tax revenue as % of total tax revenue	Calendar year	Sales tax revenue as % of total tax revenue
1965	5.1	1975	14.2
1968	10.1	1976	18.1
1971	17.8	1977	26.1
1972	17.6	1978	29.8
1973	16.3	1979	31.4
1974	15.5	1980	25.8

Source of data: Ministry of Economic Planning and Development, *Annual Economic Review of Zimbabwe,* August 1981.

As noted below, manufacturers can buy materials and parts becoming physical ingredients of their products tax-free, but industrial machinery (except that bought by municipalities and some statutory corporations) is taxable. An earlier provision allowing refund of tax on machinery was eliminated.

Real property contracts are not taxable; contractors are subject to tax on their purchases.

Thus basic necessities of the lowest income groups, medicines, and some farm inputs are exempted. Some cascading results from taxing farm and industrial machinery and other inputs, but this is justified in part on the objective of lessening capital intensity, which is believed to be very high.

Exports are exempt from tax; on a retail sale, the retailer, not the customer, can apply for exemption. Thus goods purchased by a tourist for delivery outside the country are not taxed.

Services

Until 1980 the tax applied only to commodities (including rental of taxable goods). In 1980, however, a limited number of specified services were made taxable, by defining them to be sales of goods:

(1) Hotels and restaurants.
(2) Transportation by air and water, taxis, and some bus service. Rail service is not taxable within the country, but is in part on intercountry charges.
(3) Telecommunications.

Repair services are not taxed, tax applying only to the parts.

3. In calculating exempt sales, bread, maize meal, and milk may be valued at purchase price plus 15%.

Taxable price and other features

The tax applies to the total price, including charges for delivery other than by air, rail, or other public vehicles, but not interest charges, and after deduction of discounts given. No adjustment is allowed for trade in allowances.

Liability for tax is incurred at the time of sale, rather than at the time of payment, even on installment sales, and no adjustment is allowed for bad debts.

The amount collected from the customer to cover the tax must be included in gross sales whether the tax is quoted separately or not, but is factored out on the tax return (note Fig. 1), and thus the tax does not actually apply to this sum.

Tax applies to goods taken from stock for the firm's own use or that of its owners, and a special line is provided for this on the tax return.

Used goods are taxed when sold by a registered trader; casual sales by individuals are not taxed, nor are sales by firms of capital assets or other goods they do not sell in the course of their business.

When a firm previously operating but not registered does register, adjustment is made for inventory on hand on which it has paid tax when purchased.

Rates

As noted, initially the tax had only one rate, 10% as of 1976. In 1977, the government raised the rate to 15% to gain more revenue. In 1980 the new government reduced the rate to 10%. But revenue needs were so great that as of August 1981, the basic rate was raised to 12.5%, and a rate of 15% applied to a range of "luxury" items noted below. In August 1982 the two rates were raised to 15% and 18%.

The higher rate in general applies to consumer durables. Some 14 categories are listed, but these can be grouped into a smaller number for simplified presentation:

(1) Motor vehicles.
(2) Accounting, calculating, and data processing machines; office machinery and apparatus.
(3) Air conditioners.
(4) Furniture.
(5) Refrigerators, deep freezers, ovens, a wide range of electrical appliances.
(6) Radios, TV sets, recorders.
(7) Clocks, watches, cameras.

There were two objectives: to make the tax less regressive, and to discourage purchases of these durable items for foreign exchange reasons (many ingredients are imported).

III. ADMINISTRATION AND OPERATION OF THE TAX

In early years of the tax, it was administered by the Revenue Department. When that department was broken up, the sales tax was assigned to Customs and Excise. Ultimately the portion on domestic sales was transferred to the Department of Taxes, which also administers the income taxes.

The sales tax administration faces a major problem that had its origin in the period when the tax was established. The administration set up a qualification requirement of 5 years of bookkeeping or accounting experience. A number of retired persons in their early 60s were hired; they were well-qualified, and could be obtained for relatively low salaries – essentially supplements to their pensions. This policy has been continued, but when the new government took over in 1980, it proceeded to require employees over 60 to retire. The result was to cause serious loss of trained personnel. But the low salary levels – $7,000 to $9,000 a year – and the 5-year experience rule made it very difficult to hire new persons with reasonable qualifications. It is not a career oriented service, taking in younger competent persons who will make a career of the work. There is continued heavy turnover of staff; persons get some training and then leave for positions offering a little more money. A number of senior personnel have left for work in the private sector since they did not see a good future in tax administration.

Current plans call for establishing a cadet group, taking persons out of secondary school, giving them extensive training, and seeking to keep them on a career basis.

Administrative organization

The Department of Taxes is headed by the Commissioner of Taxes, under the jurisdiction of the Ministry of Finance. There are 4 deputy commissioners, one for direct taxes, one for indirect, and two for various problems common to both. There are 5 assistant commissioners, one of whom has general supervision of the sales tax. There are district offices in 4 locations: Harare, with three collection offices; Bulawayo; Gweru; and Mutare (formerly Umtali). Operation is substantially decentralized, with basic files kept in the district offices, to which returns and payments are made and from which examinations of accounts are performed.

The authorized staff for sales tax consists of one Chief Tax Examiner, who has direct charge of operations; 4 Senior Principal Tax Examiners, one in charge of each of the 4 district offices; 10 principal tax examiners, and 41 tax examiners, assigned to the district offices. There is currently a serious shortage of staff; there are 25 staff vacancies, and many of the examiners have had limited experience as yet. There is one authorized examiner per 146 accounts; with the current vacancies there is actually one per 263 accounts. Even the latter is a very favorable ratio compared to that in most countries, and the authorized ratio should be adequate if the persons were well trained. Unlike in many African countries, there has been no effort to hire expatriates.

Operation of the tax: registration and small firms

Registration is required of all firms selling taxable goods, including manufacturers and wholesalers as well as retailers, except small firms; those with annual gross taxable sales under $20,000 (about US$ 26,000). This small firms exemption, in the view of the administration, works well, although wholesalers are given some problems in determining whether or not their customers are

FIGURE 1

G.P. & S. 16527-N.

S.T. 4

DEPARTMENT OF TAXES
SALES TAX ACT [*CHAPTER 184*]

RETURN OF SALES/AUCTION SALES [Section 14 (1)]

Month ending ...., 19. .....

Letter

Notes	
A. The leasing of goods is classed as a sale for the purposes of the Act, so rentals receivable from the hiring of goods must be included in the value of cash and credit sales in this return.	1. Registration certificate number..................
B. Please complete the receipt form below.	2. Name of registered operator ....
C. When completed, this form (intact) should be sent, with remittance, to the collector of taxes responsible for the area in which you are registered (see reverse).	Trading as ....
D. Severe penalties may be imposed for the late payment of tax.	3. Postal address ....

(*To the nearest* $)

4. Total cash and credit sales of goods other than those specified in Part 1 of the Schedule to Chapter IV of the Finance Act [*Chapter 179*] during month (including sales tax charged) . . . . $..................

Less credits passed and/or journalized . . . .

SUB-TOTAL . . . . . . $..................

(*To the nearest* $)

Deduct: Exemptions—

(a) goods exported from Zimbabwe . . . .

(*b*) goods sold to registered operators in terms of section 12 of the Act (after deducting discounts and credits passed and/or journalized) . . . .

(*c*) bread (may be valued at purchase-price + 15 *per centum*) . . . .

maize-meal (may be valued at purchase-price + 15 *per centum*) . . . .

milk (fresh, sour, sterilized, skimmed or separated) (may be valued at purchase-price + 15 *per centum*) . . . .

(*d*) other—specify separately (i) . . . .

(if insufficient space detail overleaf) (ii) . . . .

Total exemptions . . . . $ ....

Net taxable sales during month $ ....
(*Including tax*)

$ c

5. (*a*) Tax on net taxable sales above at 15 *per centum* . . . .

Less 3/23rds, being allowance in respect of tax on tax. . . . .

SUB-TOTAL . . . .

(*b*) Tax on goods applied to own use or use of any other person:

Cost of goods so applied $..................; tax at 15 *per centum* . . . .

TOTAL TAX DUE . . . .

I hereby certify that this return is correct in every particular.	**FOR OFFICE USE—** Cash register figures
Date ...., 19.........	
Signature	

registered. There appears to be little tendency for firms to avoid registering or split into two or more firms to get under the line. If they are not registered, tax applies to their purchases and thus at an earlier date; their liquidity position is reduced, and they do not get the advantage of collecting tax from customers in advance of payment to the government. This appears to more than offset the disadvantage of having to file tax returns and have their markup subject to tax. The sales tax administration relies primarily on income tax returns to ascertain borderline firms that should register. The $20,000 figure, raised from $10,000 in 1978, appears to be satisfactory in delineating between the very small shops that cannot easily be controlled and those that can. Firms below the line are not given the option of registering.

There is considerable turnover of firms, more than in the past, as a result of changes in the economy, foreign exchange controls, and the like.

When a firm is registered, it is given an account number and entered into the master file, kept in a ledger. There is no computerization, although this is being planned currently. Firms are classified by area and by type of business.

As of October 1982, there are 8,160 registered firms, called registered operators or registered traders. The number has been rising slowly; the 1980 figure was 7,309, the 1981 figure, 7,895. The 1982 figure constitutes one registered firm for each 940 persons, a very low figure compared to registration under the retail sales taxes in the United States – a reflection of the fact that much of Zimbabwe's population is dependent on semi-subsistence agriculture.

Of the current registration, 4,896 (over half) are located in the Harare district, or 1 per 122 persons; 1,808 in Bulawayo, 959 in Gweru, 524 in Mutare. The 8,160 compares with 9,784 employers subject to PAYE (some are not subject to sales tax), and about 12,000 companies.

Firms with branches can register each separately, or singly for the entire operation. With the trend toward computerization, more firms are using single registration. New firms are given a brief, concise *Trader's Guide to Sales Tax,* which provides instructions on the operation of the tax and gives samples of the various forms used. Further information is provided in person.

Returns

A copy of the return form is reproduced in Fig. 1. Two separate forms are used, one for the 15% rate, one for the 18% rate. Batches of forms are provided to the registered operators. The forms are not preprinted with the name and registration number of the firm, which will be made feasible by computerization. Returns and payments, made together, come in to the district offices, partly by mail, partly by messenger. In Harare, many come by messenger, so that the firm gets an immediate receipt. Only one copy of the return is required.

As the return forms come in, the amount is recorded by hand in the registers. Returns are due monthly, by the end of the following month.

Non-submission of returns (non-filing)

Failure to file a return and pay is ascertained by a manual check, in the district offices, of the ledgers in which payments are recorded, by the end of the second month. The percentage of non-filers currently runs from 7.5 to 10% each month. The figure was lower in the past; the current figure is a result of the use by business firms of inexperienced help.

The penalty for failure to file on time is 100% of the tax due, an extremely severe one by comparison with other countries. The Tax Department can reduce the figure below 100%, and often does, for extenuating circumstances. In 1981, penalties assessed for late filing of returns and on the basis of examination of returns totalled $1,003,746, 38% of the amount of additional tax assessed. The additional assessments and penalties have been rising very rapidly, mainly as a result of inexperienced help.

Discretion is left to the district offices as to the techniques to use to obtain returns and payments from the non-filers. Phone calls, letters, or visits may be used, depending on the circumstances. The district office personnel, at least in the past, know the clients and the best techniques to use. Most non-filers do file and pay after the initial contact. If they do not, an assessment may be made and legal action taken, as for example, a suit, and the firm can be put out of business. But rarely is this done, as it involves a lengthy legal process, and the government obviously does not want to force businesses to close down.

Examination of returns (audit)

The objective is to examine 40% of all accounts each year, allowing all registered firms to be examined within the 3-year statute of limitations period. Currently, with an inexperienced staff, this objective is not being fully attained. In 1981, 18% of the accounts were audited, in 1980, 25%. Even so, this compares very favorably with the experience in other countries. The district offices establish the priorities for selection of firms for examination, primarily on the basis of experience in the past. Examination is done in the field. Both understatement of gross sales and overstatement of exempt sales are found extensively.

Firms may file objections to the result of the examination; these are reviewed in the head office by the Assistant Commissioner, but decided on by the Commissioner of Taxes. In 1981, 35 objections were filed and 3 pending; of these 10 were disallowed, 10 allowed in full, 5 partly allowed, 7 withdrawn, 6 pending. Appeal may be made to the Fiscal Appeals Court, a special court under the jurisdiction of the Attorney General, which also hears customs appeals. There were 3 sales tax appeals in 1981. Only one sales tax case has been appealed further.

Separate quotation of tax

Firms are allowed, by law, the option of adjusting the sale price to include tax (add-in) or of quoting the tax separately from the posted prices (add-on). With the former, the trader may indicate that the price is tax-inclusive although he may not state that the goods are tax-free, with the add-on method, the trader must adhere to the schedule provided by the Tax Department; for example, with the 15% rate, nothing is collected on sales under 3 cents, 1 cent on sales between 3½ and 10 cents.

In contrast to the United States and Canada, both methods are used extensively. Some estimates suggest that they are about of equal importance; others, that the add-on method is dominant. As one example, newspapers and magazines frequently indicate in print on the cover page: tax included.

Major problems in the operation of the tax

There are several major problems in the operation of the tax – but less so than might be expected.

1. *Misuse of purchase exemption certificates (ST3s).* Registered firms can buy tax-free for resale or for use as materials or parts by executing an exemption certificate form, and placing their registration numbers on each purchase invoice. The Tax Department has found serious misuse of these certificates. Primarily, unregistered firms produce fraudulent certificates, ones which they are not entitled to use, with fictitious numbers, names, and addresses. Wholesale suppliers find it difficult to check on the legitimacy of the certificates given them. The current loss of revenue from this practice is apparently substantial.

2. *Purchases by farmers.* In earlier years of the tax, farm purchases created few problems; commercial farmers were required to have farm licenses and to indicate their farm license number on all purchases. But with increased market activity by trust area and other indigenous small farmers, the operation became more difficult. Most of these farmers buy and sell through cooperatives, and thus a number is issued to the coöp. But control is much more difficult and the problem has not been solved; it is almost certain to become worse before it becomes better, with increased numbers of small farmers engaged in market activity.

3. *Personnel.* Administration of the tax has become much more difficult because of the loss of trained personnel. There are severe staff shortages and lack of adequate training and experience on the part of many of the examiners.

4. As noted, there is of course some under-reporting of sales and over-reporting of exemptions, the amount having increased as a result of the increases in the rate and the use of less experienced personnel.

The Tax Department reports relatively little difficulty with the exemptions, which are limited in scope and well defined, or with the use of the two rates, since the higher rate applies to well defined categories of consumer durables. Likewise, the exemption of small firms gives few problems.

There are a few technical aspects that create some confusion – the lack of a clear and workable definition of liability when exemption certificates are misused, and confusion in the tax liability of the railway system and road transport – which require solution.

The portion of sales tax collected at importation

Because of the retail nature of the tax, most of the revenue, 96% in 1980, 95% in 1981, 93% in 1982, is collected on domestic transactions. The portion on imports, called the import tax, is collected by the Customs and Excise department, as noted. Each department reports excellent cooperation by the other.

Import tax, which is a countervailing tax to sales tax, applies only to import by persons who are not registered operators, and to imports by a registered operator which are not intended for resale or manufacture. Registered operators can import tax-free for resale by quoting their registration number, or for manufacture by certifying this, on the customs clearance documents. If firms import tax-free and then use the goods for taxable purposes, this is deemed as a sale and must be declared to the Sales Tax Department as such.

The tax on imports applies to duty-paid value, not including the current import surcharge (15%). By law the Minister has the power to apply uplift to the taxable value up to 60% of the value, but in practice this is not done. As the tariff is on a FOB basis, transport costs to Zimbabwe are not included in the taxable figure, to the possible detriment of domestic producers. But this has not been an issue, partly because of rigid import controls. Some undervaluing for customs is encountered, but most is done for exchange control rather than customs reasons. A new tariff consistent with that of the Customs Coordinating Council is being developed, but with the FOB basis retained.

The exemptions and rate structure are essentially the same as in the domestic portion. A few import transactions are exempt from tax whereas their domestic counterparts are not. For example, imports by government are exempt while domestic purchases are taxable. Purchases by hospitals and schools are similarly treated; pets, vaccine, and film are exempt on importation, not on domestic sales except when purchased by certain institutions. But these are all special cases. There has been only one minor instance where imports are freed while domestic sales are taxed.

The tax is collected in conjunction with customs duties, on the same form, prior to clearance. No specialized personnel are used. When questions of interpretation arise, Customs relies on the Tax Department to ensure uniformity. A question arose, for example, over bulbs, which are classed as seeds for tax purposes but not customs.

IV. CRITICISMS OF THE TAX

Despite the high rates and the broad coverage, there appears to be relatively little general criticism of the tax. When the tax was imposed it was highly unpopular and criticized for being regressive, and this complaint is still heard. But the tax appears to be widely accepted. While the government has expressed concern about the overall regressiveness of the tax structure, it accepts the sales tax as a highly important revenue source and raised the rate again in 1982. The tax is praised by many as ensuring that virtually all persons make some contribution to the cost of government.[4] The exemption of basic foods, on which the very poor spend most of their incomes, and the non-taxation of the products of subsistence agriculture, the chief source of livelihood of the rural poor, result in relatively little burden on the very poor, urban and rural. These groups likewise are now benefitting to an increasing extent from governmental expenditure programs. The probable regressiveness of the sales tax is offset at the higher income levels by the progressive income tax. A broad based sales tax has many equity (as well as revenue) advantages over very high excises on a few commodities, as found in many countries. While the tax is criticized as dampening consumption, this is in part deliberate, in an economy which is suffering from some shortages, excessive aggregate demand, and severe foreign exchange problems.[5] It is recognized, however, that the tax does affect the cost of living and thus wage negotiations.

The tax is likewise apparently generally accepted by the retail community – in great contrast to the violent fight waged by the retailers in Australia against the proposal in that country to move the sales tax from the wholesale to the retail level. The chief complaint of the business community appears to be that the failure of the Tax Department, because of personnel shortages, to act quickly on firms not filing and paying tax results in the accumulation of substantial liability; when the firm fails the government has first claim, and other creditors may receive nothing.[6]

There are, however, certain sectors of the economy in which the tax is believed to cause injury through lessened purchasing. For example, the sales tax was regarded as a major factor in the discontinuance of the once popular "Skycoach Package Holidays to Durban", since the tax applied to the entire package when acquired in Zimbabwe.[7] But the opening of other tourist spots to Zimbabwians following independence was undoubtedly a factor as well.

The hotel industry within Zimbabwe is likewise concerned about the effect of the tax upon their business, particularly since occupancy rates are currently low – 36% in the period May–August 1982, compared to 54% in 1980.[8] Obviously the sales tax was not a major source of the decline – but the low occupancy rate increases concern over possible effects of the tax.

An inherent problem suggested by the Skycoach case relates to the attempt under the tax to reach expenditures made for transport and accommodations outside the country. There is obvious merit in taxing such expenditures, as basically these are luxury activities and the taxation of them lessens the use of foreign exchange and makes the tax less regressive. But experience suggests that it is very difficult for a country to tax activity outside its borders. Only the exchange control system, which rigidly restricts holiday allowances but does not charge expenditures for foreign travel and hotels paid for in Zimbabwe against the allowance, makes it feasible at all. Persons having sources of funds outside the country will simply buy tickets to a neighboring country and then make the additional travel expenditures free of tax.

The tax does contain cascade elements, primarily because industrial machinery is subject to tax. This issue has been debated extensively in many developing countries. Total real investment may be reduced somewhat, as the cost of such investment is increased by the amount of the tax; even if the tax can be shifted to users of the products, greater money capital is required initially. However, in a country in which there tends to be a surplus of labor, and capital is relatively scarce, in which wages are pushed up by minimum wage laws, and imported capital goods are made artificially cheap by an overvalued exchange rate,[9] production may become excessively capital-intensive relative to the economic optimism, and the sales tax may aid somewhat in restoring the balance. On the whole, this feature of the tax has not been subject to much criticism.

V. GENERAL EVALUATION

The sales tax has been highly effective in yielding revenue – one fourth of the total tax revenue – a percentage surpassed by very few, if any other, developing countries. In most such countries the sales tax yields much less than the excises. The yield of the tax in 1981, before the recent rate increase, equalled 4% of gross domestic product, also a very high figure by world standards, or in 1979 about 9% of estimated domestic consumption.[10] In placing a substantial burden on consumption relative to savings, the tax should have a deterrent effect on luxury consumption and thus lessen the drain on foreign exchange. There is strong opposition to further increases in income tax rates and fear that such increases would deter private sector real investment;[11] thus in the absence of the sales tax either the government deficit would be much higher than it is, or programs (such as education) contributing to development would have to be curtailed.[12]

While no studies of burden distribution are available, it would appear on the basis of experience elsewhere that the tax may be regressive. But the most serious equity disadvantage of a sales tax – the absolute burden on the poor – is mitigated by the basic food exemption, as noted. Considered as an element in a system in which income taxes are progressive and many government expenditures primarily benefit the low income groups, it is difficult to condemn the tax too severely by usual equity standards.

The widespread acceptance of the tax, despite its very high rate, is an obvious advantage, in terms of popular at-

4. For example, in the 1982-83 Budget statement.
5. This should not be exaggerated; inflation, about 14% early in 1982, has not been much higher than that in industrial countries, and shortages and foreign exchange problems do not compare with those of many African countries.
6. This was stressed in discussions by the Associated Chambers of Commerce of Zimbabwe.
7. *The Financial Gazette,* Harare, Oct. 8, 1982, p. 1.
8. *Ibid.* The figure in Victoria Falls was only 29%, Harare, 40%.
9. The appropriate exchange rate with the U.S. dollar is estimated to be about 1 to 1 instead of 1.31 to 1.
10. Based on data in Zimbabwe, Central Statistical Office, *Monthly Digest of Statistics,* August 1982.
11. The personal income tax is progressive to 60% at about $35,000.
12. There is possibility of some additional revenue from companies and large firms. The company tax rate is 51.75% but investment allowances are very liberal.

titudes and willingness of the retail firms to cooperate in the functioning of the tax.

The tax, with a minimum of exemptions and a relatively simple rate structure, the higher rate confined to clearly delineated goods, appears to operate with a minimum of difficulties. There is, of course, some leakage, as noted. But the 1979 yield constituted roughly 13% of taxable consumption expenditures, with a 15% tax rate.

This is not a precise figure, and some of the revenue came from non-consumption spending – but the figure is clear evidence that mass evasion is not occurring.

The use of the retail form of sales tax has been questioned at times because of the large number of taxpaying firms. But the retail tax has important advantages. The yield at a given tax rate is maximized. The tax avoids discrimination against particular distribution channels and against domestic relative to imported goods (and in a few cases the reverse), and consequent changes in methods of doing business that have plagued the Canadian manufacturers' sales tax for 50 years and have become of increasing concern in New Zealand. The argument that the retail tax cannot be used effectively in a developing country is clearly not relevant for Zimbabwe, given the high productivity of the tax and the limited criticism.

This raises the interesting question of why the tax has succeeded. There are several reasons. First, while no data are available, it is obvious that a large portion of the total retail sales is made in the major cities, in which retailing is essentially a commercial venture, not a family household activity or sideline. These firms buy from established wholesale sources, and control is not difficult. Secondly, unlike many developing countries, Zimbabwe has a substantial well-educated business community which carries on a large portion of retailing. Finally, during most of the years of the tax, the country was experiencing one crisis after another: the breakup of the Federation, U.D.I. and the resultant sanctions and disruption of trade channels, the war, independence, and severe foreign exchange deficits, met by direct import controls, rather than revenue-producing customs. Crises inevitably divert attention from such matters as taxes, and make many persons less eager to evade them.

VI. CONCLUDING OBSERVATIONS

The government has indicated plans to create a Tax Commission to examine the entire tax structure, and certainly the sales tax will be reexamined. The sales tax is a significant and highly productive element in the tax structure. While criticized as regressive, it does avoid placing a burden on the lowest income groups. Criticism does not appear to be substantial. The experience has shown clearly that a developing country can use a retail sales tax successfully under the right conditions. Thus in any revision of the tax structure, there would be great merit in retaining the tax as it is, with minor modifications. The alternatives – a manufacturers' or wholesale sales tax – while easier to collect, lead to continuing problems that grow worse rather than better with development. The retail tax, together with the value added tax through the retail level, is the ideal form of sales tax, and it would be a great mistake to go back to a less acceptable version. In time it may be desirable to convert the present tax into a value added tax to ensure substantial collection at pre-retail levels, but this is not the time to make drastic changes of this type. Similarly there is merit in not multiplying exemptions,[13] but to seek to improve equity in the tax structure by adjusting other levies, particularly the income taxes. There is similar merit in not adding additional rates.

The greatest threat to continued success of the tax is the loss of trained personnel. It is imperative that the sales tax operation be established on a career oriented basis, with adequate salaries and recruitment of university graduates with substantial work in accounting as the basic cadre of senior inspectors. Persons with lesser qualifications can be trained for examining small stores, but it is imperative to have well-trained persons with university background to deal with the larger firms.

Reconsideration should be given to the application of the tax to hotels, given the great excess capacity, despite the equity advantages of taxing, and to expenditures made for activities outside the country. Taxing transport service other than air tickets is always questionable, given the desire to conserve energy.

Some classification is needed on several issues: the precise liability for tax on out-of-country and in-country travel, and the liability of suppliers or customers when exemption certificates are misused, for example. Substantial improvement in the handling of exemption certificates, both for resale and farm use, are under consideration and urgently needed. One approach is to provide suppliers with current lists of registered firms and their registration numbers; another is to allow firms to use only those exemption certificates supplied by the Tax Department with the purchaser's registration number stamped on them.

Computerization is urgently needed and is contemplated. Computerization will offer many advantages: the provision of up-to-date printouts of registered traders; preprinting of names and registration numbers on return forms, speedy determination of non-filers for immediate action (to meet the most severe criticism of the tax by the business community as well as saving revenue), simplified internal control and preparation of statistics useful for cost control; assistance in selection of firms for examination, etc., as well as simplifying many routine operations.

In conclusion: it is highly desirable to retain the tax in basically its present form, modifying other taxes to make the overall system progressive, and making a strong effort to attract and retain qualified personnel. Zimbabwe has essentially an optimal type of sales tax and good basic operating procedures; some adjustments in these aided by computerization should allow continued success with the tax. It would be a great mistake to turn the clock back by moving to a less optimal form of sales tax.

13. One that might be considered is school uniforms.

UNITED STATES:

World-wide Combined Reporting – Recent Legislative Developments

By Leonard Rothschild, Jr. and Ralph E. Anthony

In the area of state taxation, one of the most controversial issues is the extent to which a state may properly require the filing of a world-wide combined report. This article will examine certain current legislative developments affecting world-wide combined reporting.

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INTRODUCTION

Each state has the power to tax a corporation on its business income earned within that state. A problem may arise when a corporation has business activities in more than one taxing jurisdiction. In such case, the income must be apportioned among the various states (or foreign countries) in which the corporation is deemed to be doing business. The two principal methods of calculating income attributable to a particular state are the separate accounting and formula apportionment methods.

Under the separate accounting, or arm's-length, method, income from a particular geographic source is determined by examining the transactions which take place within that source, and then establishing the proper amount of income which arises from those transactions. The amount of income is established using an arm's-length approach, such as is required by Sec. 482 of the Internal Revenue Code.[1] Unfortunately, the separate accounting method is rarely allowed by most states, and the formula apportionment method is much more commonly used.

All of the states which impose a corporate income tax use some type of formula to apportion business income amoung the various states in which the corporation operates. However, the specific formulas vary from state to state.[2] Most states use some variation of the standard three-factor formula based upon sales, property, and payroll. Using the standard method, a company's sales, property, and payroll *within the state* are compared to the company's *total* sales, property, and payroll. The three ratios are then averaged to determine the percentage of the company's business income that will be subject to tax within the state. Assume, for example, that Company A has total sales of \$5,000,000, total property of \$10,000,000, and total payroll of \$1,000,000. Company A has \$1,000,000 of sales, \$3,000,000 of property, and \$400,000 of payroll attributable to its activities in State X. Company A's three-factor formula would be determined as follows:

$$\text{Sales factor} = \frac{\text{Sales within X}}{\text{Total sales}} = \frac{\$1{,}000{,}000}{\$5{,}000{,}000} = 20\%$$

$$\text{Property factor} = \frac{\text{Property within X}}{\text{Total property}} = \frac{\$3{,}000{,}000}{\$10{,}000{,}000} = 30\%$$

$$\text{Payroll factor} = \frac{\text{Payroll within X}}{\text{Total payroll}} = \frac{\$400{,}000}{\$1{,}000{,}000} = 40\%$$

$$\text{Total} = \frac{20\% + 30\% + 40\%}{3} = 30\%$$

30% of Company A's income base would be subject to tax in State X.

This article also appears in the February 1983 issue of the *Journal of State Taxation.*

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1. Assembly Revenue and Taxation Committee, *Volume 11, Unitary Method of Apportionment 44* (1979).
2. Committee on Ways and Means U.S. House of Representatives 95th Cong., 1st Sess., Recommendations of the Task Force on Foreign Source Income 25 (Comm. Print 1977).

A state's apportionment formula is usually only applied to a corporation's income where the business activities within the state are related to or dependent upon the business activities of the same corporation outside the state. Some states, such as California and Illinois, have adopted the "unitary" method of apportionment. Under this method the apportionment formula is applied not only to the income of the specific company operating within the state, but also to the income of any related corporation (parent corporation, subsidiaries, and brother-sister corporations) where the related corporation's activities outside the state contribute to or are dependent upon the activities within the taxing state.[3] The unitary method of apportionment has been applied to domestic operations, and in many cases to include certain foreign operations.

Application of the unitary method to foreign operations has created many problems and inequities. The fundamental basis of the unitary reporting method is that there is a "unity" of ownership, use, or operation of the various entities in the conduct of a single trade or business. The determination of whether a unitary group exists is often subjective, and it may be very costly for a multinational corporation to demonstrate that its business operations do not constitute one or more unitary businesses. The California Franchise Tax Board has developed a lengthy list of detailed questions which serve as a basis for determining whether world-wide combination of a group of affiliated corporations is appropriate.[4] The adoption of objective criteria would help provide stability and certainty to businesses operating within or considering expanding to a particular jurisdiction. Unfortunately, there are few objective criteria available which clearly articulate the definition of a unitary business.

An even more formidable task is determining the taxable income of the members of a unitary group of corporations. Foreign parent companies, and foreign subsidiaries of such companies, typically do not maintain their books and records in accordance with United States generally accepted accounting principles or in accordance with United States or state tax accounting principles.[5] Fluctuations in exchange rates pose particular problems in constructing apportionment data and determining income for foreign parent companies, as accounting data for the foreign subsidiaries must be first translated from local currency into the currency of the parent's domicile before being translated into United States dollars.

The unitary method and the standard three-factor formula for apportioning income, when applied to a multinational business, generally increase the income subject to state tax because the formula is based upon the following erroneous assumptions:

(1) all members of the unitary group are operating in a homogeneous market where wages, sales prices, profit margins, and costs of business property are the same;
(2) there are no long-time differences in the economic, political, and social conditions in the United States and overseas;
(3) every dollar spent on wages, received from sales, or invested in tangible property will earn for each member of the unitary group the same income; and
(4) the actual profit earned by each member of the unitary group cannot be determined under arm's-length pricing of intercompany transactions.[6]

These assumptions may be faulty for a variety of reasons. Wages in the United States are higher than in many less developed countries. Property costs in the United States are generally higher than elsewhere in the world. The sales factor can result in distortions because it ignores the fact that profit margins may differ because of local economic and political conditions. Faced with the risk factors of doing business abroad (including: nationalization, expropriation, and excessive governmental regulation), multinational corporations generally will not invest in politically and economically unstable countries unless profit margins are high enough to enable the corporation to recover its investment more quickly than it could in a more predictable environment. Each of these factors can cause an overallocation of income to a particular state.[7]

The California legislature has attempted to address the problem of overallocating income to a taxpayer's business operations in California by enacting Sec. 25137 of the Revenue and Taxation Code. This section provides that if the allocation and apportionment formula does not fairly represent the extent of the taxpayer's business activity within California, the taxpayer may petition for, or the Franchise Tax Board may require:

(1) the use of separate accounting;
(2) the exclusion of any one or more of the apportionment factors;
(3) the inclusion of one or more additional apportionment factors which will fairly represent the taxpayer's business activity within California; or
(4) the use of any other method which would effectuate an equitable apportionment.

Unfortunately, as a practical matter, the Franchise Tax Board never allows the use of separate accounting. Furthermore, any relief from using the standard three-factor apportionment formula is generally only permitted for certain specialized industries. The reluctance of the Franchise Tax Board to grant relief under Sec. 25137 is one reason the unitary tax issue is now before the United States Supreme Court.

Over the past several years, federal and state legislatures have considered the problem of state taxation of multi-jurisdictional corporations. The states vary greatly in the extent to which they utilize the combined reporting concept. Twenty-seven of the 46 states which tax corporate income apply some form of combined reporting to unitary businesses. Thirteen states have adopted world-wide reporting for at least some purposes.[8] Much of the recent

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3. Id.
4. "State Taxation of Foreign Source Income: Hearings on H.R.5076 Before the House Committee on Ways and Means", 96th Cong., 2nd Sess. 261 (1980) (Statement of William O. Hetts).
5. Id.
6. Id. at 262.
7. Id.
8. Letter from Illinois Governor James Thompson to the Honorable Members of the House of Representatives 82nd General Assembly (20 September 1982).

legislative attention has focused on whether or how the combined reporting concept should be applied to the non-United States operations of a unitary business.

INCOME TAX TREATIES

The first recent national attention to the world-wide combined reporting issue occurred during the United States–United Kingdom Income Tax Convention negotiations. The treaty was signed 31 December 1975, but did not enter into force until 25 April 1980.[9] As originally negotiated, Art. 9(4) of the Convention would have prevented the federal government and the states from extending the unitary method on a world-wide combination basis to related foreign enterprises, where the enterprise doing business in the state was a British enterprise or a United States corporation controlled directly or indirectly by a British enterprise.[10] Much of the delay in ratification of the treaty can be directly attributed to a concerted effort by the states to have this provision deleted.

A proposed reservation which would have deleted the provision as applied to states was defeated in the Senate. However, the Senate failed to ratify the treaty containing the original Art. 9(4).[11] On 27 June 1978, the Senate gave its advice and consent to ratification of the treaty subject to the reservation that Art. 9(4) would not apply to any state or local authority of the United States.[12] The reservation was incorporated in the Third Protocol to the treaty (signed 15 March 1979), which was approved by a Senate vote of 98-0. In its report on the protocol, the Senate Foreign Relations Committee urged the tax-writing committees of Congress to hold hearings on the unitary issue.[13]

A British note to the State Department expressing its grave concern on the unitary issue stated, *"The unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory"*, and *"the tax consequences are unpredictable and arbitrary"*. Final approval of the treaty was given by the House of Commons with the understanding that Congress would address the unitary tax problem.[14]

Although the United States–United Kingdom Income Tax Convention focused a considerable amount of attention on the unitary tax issue, other foreign governments have also protested the use of the unitary method. For example, in an exchange of notes accompanying a 1978 protocol to a treaty with France, the French took the position that to require a French multinational corporation with subsidiaries in several countries to submit all its books and records to a state, in English, would prove to be a costly administrative burden.[15]

The treaty negotiation controversy has generated some legislative action at both the federal and state levels. Several federal bills have been introduced in the past few years. This article will examine a few of the bills which have received the most attention.

PROPOSED FEDERAL LEGISLATION

In 1977 the House Committee on Ways and Means established a task force to study the taxation of foreign-source income. One area specifically addressed by the task force was state taxation of foreign-source income. The study examined alternatives for limiting the application of the unitary method of apportionment and the direct taxation of foreign-source income. In regard to the unitary issue, the task force examined three main alternatives:

(1) States could be prohibited from requiring the reporting of income and related items of foreign corporations even though related to U.S. corporations operating in the state. The unitary method would not be applied to foreign subsidiaries of U.S. corporations, to foreign parents of U.S. corporations, or to other foreign affiliated corporations.
(2) The reporting of income and related items of foreign corporations could be limited to activities of U.S. corporations which relate to exports from or imports to the United States.
(3) The reporting of income and related items could be barred in the case of foreign-owned affiliates operating within a state, but allowed with respect to foreign affiliates of U.S. corporations.[16]

The task force made the following recommendations:

(1) States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the states unless and until that income was subject to federal income tax.
(2) No limitation be placed on the states' power to apply the three-factor formula on a domestic basis to income of foreign affiliates once it becomes subject to federal income tax.[17]

After the task force made its recommendations, Congress responded by addressing the unitary issue.

H.R. 5076 (Conable)[18] and S. 1688 (Mathias)[19] were introduced in August 1979. Both bills sought to conform state rules to the federal rules in two respects:

(1) the time at which states may tax the foreign income of foreign affiliates, and
(2) the amount (or portion) of foreign-source dividends which could be taxed.[20]

The bills incorporated the Ways and Means task force recommendation that a state could not take into account

9. Treaties and Other International Acts Series (TIAS 9682), published by the U.S. Government Printing Office in Washington, D.C.
10. Staff of Joint Committee on Taxation, 96th Cong., 1st Sess., Description of S.983 and S.1688 Relating to State Taxation of Interstate Business and Foreign Source Corporate Income 17 (Comm. Print 1980).
11. Id. at 18.
12. Treaties and Other International Acts Series (TIAS 9682), published by the U.S. Government Printing Office in Washington, D.C.
13. Description of S.983 and S.1688, see note 10, at 18.
14. "State Taxation of Foreign Source Income: Hearings on H.R.5076 Before the House Committee on Ways and Means", 96th Cong. 2d Sess. 152 (1980) (Statement of Edward L. Hennessy, Jr.)
15. Description of S.983 and S.1688, see note 10, at 18.
16. Recommendations of the Task Force, see note 2, at 27.
17. Id. at 30.
18. H.R.5076, 96th Cong. 1st Sess. (1979).
19. S.1688, 96th Cong., 1st Sess. (1979).
20. California Assembly Revenue and Taxation Committee, Unitary Method of Apportionment: New Developments 18 (1981).

the income of a foreign affiliate until the income was subject to federal tax.

Under the timing provision, the foreign-source income of a foreign subsidiary of a U.S. parent would be taxed if and only to the extent the earnings were remitted to the United States parent as a dividend or deemed to be remitted under the provisions of Subpart F of the Internal Revenue Code. Since the foreign-source income of a foreign parent (and the unremitted foreign-source income of foreign affiliates of a U.S. corporation) generally is not taxable under the Internal Revenue Code, such earnings could not be taxed by the states.

In the case of dividends received by a U.S. parent from a foreign subsidiary, H.R. 5076 and S. 1688 permitted the states to tax only the same proportion of the dividend that was effectively taxed by the federal government. When a dividend is paid by a foreign subsidiary to its U.S. parent, in order to avoid double taxation, the federal government unilaterally allows a credit for foreign taxes paid on the income. For example, if the foreign tax rate is 23% and the United States tax rate is 46%, generally only one half of the dividend is effectively subject to federal taxation. The states, on the other hand, effectively tax 100% of the dividend. Under a rather complex set of rules, the bills would have allowed the states to tax only one half of the dividend in the above example.[21]

Status hearings were held before the House Committee on Ways and Means in March 1980, but no further action was taken by the full Congress.

S. 655 (Mathias, introduced 10 March 1981)[22] and H.R. 1983 (Conable, introduced 23 February 1981)[23] were substantially the same as S. 1688 and H.R. 5076. There were no changes in the tax treatment of income received from foreign affiliates. Although several technical corrections were made in the dividend provisions, the underlying concept remained the same. States would be allowed to tax only a percentage of foreign dividends received.

No action was taken on these bills during the last legislative session. It is expected that S. 655 and H.R. 1983 will be reintroduced in the current legislative session, but that no action will be taken on the bills until after the United States Supreme Court rules on the unitary tax cases now under consideration. Although there were certain defects in the Mathias-Conable bills, passage of the bills would have clarified the unitary tax issue with respect to multinational corporations.

One other bill which received a considerable amount of attention was S. 983 which was introduced by Senator Mathias in 1979.[24] The bill contained provisions to limit unitary taxation and to also limit state collection of sales and use taxes and gross receipts taxes on the sale of personal property. The unitary taxation portion of this bill provided that only U.S.-source income would be taxed. The bill required states to use a uniform method of apportioning the income of a corporation that was taxable in more than one state. If more than one state had jurisdiction to tax, the bill provided, in general, that the determination of the allocable and apportionable income attributable to a state would be determined under that state's law with the following modifications:

(1) dividends (other than foreign-source) received from a less than 50%-owned subsidiary must be allocated to the recipient's domicile;
(2) dividends from a more than 50%-owned subsidiary are not taxed by any state; and
(3) foreign-source income of a multistate corporation is not subject to tax in any state.[25]

Apparently, under the bill the foreign-source income of a corporation which is taxable only in one state could be subject to tax in that state, since the modifications apply only where more than one state has the jurisdiction to tax. No action was taken on this bill, and a similar bill was not introduced in the last legislative session. It is unlikely that a bill of this type, which provides specific rules that a state must follow in collecting its income tax, would be passed by the United States Senate.

Since no federal legislation has been enacted to limit use of the unitary method, it is important to examine recent action taken by state legislatures. Most of the state legislative proposals have been concentrated in California and Illinois. The United States–United Kingdom treaty negotiations and the pending United States Supreme Court case of *Container Corporation of America v. Franchise Tax Board* have highlighted the problems caused by California's application of world-wide unitary reporting.[26] Illinois' combined world-wide reporting for unitary businesses has received national attention in the *Caterpillar Tractor Co.* case which is also pending before the United States Supreme Court.[27]

PROPOSED CALIFORNIA LEGISLATION

In the preamble to AB525 (Hughes), several reasons were stated for limiting the use of world-wide combined reporting:

(1) accounting methods in general use by foreign-based taxpayers are materially different from accounting methods used by United States-based taxpayers;
(2) income statements prepared under foreign accounting standards are not readily converted into income statements based on the California Bank and Corporation Tax Law;
(3) problems exist in accounting for changes in foreign exchange rates in constructing apportionment data of foreign-based taxpayers on a basis consistent with that used to determine income earned in California by United States taxpayers;
(4) the cost of converting income statements of foreign-based taxpayers to income statements more comparable to those of United States-based taxpayers is often greater than any resulting California tax liability; and

21. Description of S.983 and S.1688, see note 10, at 22.
22. S.655, 97th Cong., 1st Sess. (1981).
23. H.R.1983, 97th Cong., 1st Sess. (1981).
24. S.983, 96th Cong., 1st Sess. (1979).
25. Id.
26. Container Corporation of America v. Franchise Tax Board, 117 Cal. App. 3rd 998, 173 Cal. Rptr. 121 (CT. App. (1981)), No. 81-523 (prob. juris, noted, 3 May 1982).
27. Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d. 102 (Ill. 1981), Chicago Bridge and Iron Co. v. Caterpillar Tractor Co. No. 81-349 (prob. juris. noted, 9 November 1981).

(5) inclusion of foreign income in determining the California tax liability of foreign entities has frequently resulted in unfair taxation of foreign-based taxpayers and has acted as an impairment to investment in California, thereby hindering creation of new opportunities for employment and diversification of the state's economic base.[28]

In response to these concerns, several bills have been introduced in the California legislature. AB525 (Hughes, introduced in February 1979) exempted foreign domiciled corporations and their subsidiaries from world-wide combination under the unitary method of apportionment. Under this bill, the income and apportionment factors of a corporation or other entity would not be included in a combined report if the following requirements were met:

(1) the entity was created or organized under the laws of a foreign country;
(2) the entity was not owned and controlled by a U.S. corporation or residents of the United States; and
(3) more than 50% of the corporation's operations were outside of the United States.

These corporations, however, would remain subject to the unitary method of apportionment on the income and apportionment factors attributable to activities within the United States. Under the bill, as introduced, foreign energy and steel companies would remain subject to world-wide combined reporting even though the above requirements were satisfied. Domestic multinational corporations would remain subject to the application of world-wide apportionment factors on world-wide income.[29]

The bill easily passed the California Assembly in 1980. The Senate passed a version of the bill that would have also allowed foreign energy companies the benefit of the legislation. After the conference committee adopted the Assembly version of the bill, the Assembly passed the bill on 31 August 1980, but the bill failed to secure the needed votes in the Senate.[30] Several proponents of the bill argued that the bill failed to obtain Senate approval because of the lobbying efforts of certain foreign energy companies which were excluded from the benefits of the bill.

The central issues of AB525 were reviewed by the Assembly Revenue and Taxation Committee during hearings held in November 1980.[31] AB55,[32] a virtual repeat of AB525, was introduced by Assemblywoman Hughes in December 1980. This bill also excepted foreign owners of agricultural property and foreign energy and steel companies from the general relief provisions.[33] The last legislature failed to pass the bill and it is uncertain whether the bill will be reintroduced in the current legislative session. The Franchise Tax Board estimated that adoption of AB55 would have resulted in a revenue loss of approximately $40,000,000 for fiscal 1982.[34]

In March 1981, Assemblyman Sterling introduced the Senate version of the defeated AB525 as AB765.[35] The bill limited the application of the unitary method of combined reporting to the domestic operations of all foreign-based corporations. Unlike AB55, the bill extended relief from world-wide unitary taxation to foreign energy and steel corporations and foreign owners of California agricultural land. Domestic multinationals would have remained subject to the world-wide application of the unitary method. No action on the bill was taken by the last legislature. The Franchise Tax Board estimated that passage of AB765 would have resulted in a revenue loss of $80,000,000 for fiscal 1982.[36]

The provisions of AB55 and AB765 which provided preferential treatment to foreign-owned corporations over U.S.-based corporations could be held invalid or unconstitutional on the ground they violate the commerce clause of the United States Constitution by discriminating against domestic multinational corporations.

AB1238 (Deddeh, introduced on 19 March 1981)[37] limited the unitary method of apportionment to the domestic operations of all companies. In determining the income of an entity subject to tax, the bill provided that the income and apportionment factors of another entity would not be taken into account if the other entity had more than 80% of its average property, payroll, and sales factors during the year attributable to sources without the United States. If the corporation satisfied the 80% test, the income and apportionment factors of the corporation would be determined on the basis of separate accounting with respect to its activities within or directed from the United States.[38] No action was taken on this bill during the last legislative session. The Franchise Tax Board estimated that adoption of AB1238 would have resulted in a revenue loss of approximately $900,000,000 in fiscal 1982.[39]

Although it is possible that the three bills introduced in the last legislative session will be reintroduced in 1983, the California legislature is likely to defer action until the United States Supreme Court has ruled in the *Container Corporation of America* case. Given the current economy and the related budgetary considerations in California, it is unlikely that any bill which limits the imposition of the unitary tax method in California will become law in the near future.

ILLINOIS LEGISLATION

The Illinois Supreme Court decision in the *Caterpillar Tractor Co.* case approved the use of the unitary method for determining the income tax liability of a multistate or multinational business. Following this decision, HB2588 was introduced in the Illinois General Assembly.[40] As introduced, HB2588 would have abolished the combined or unitary method of filing. This bill was passed by the legislature on 24 June 1982 and sent to the Governor on 23 July 1982. Subsequent to passage, Illinois Governor

28. California AB525, 1979-80 Regular Sess. (1979).
29. Id.
30. Unitary Method of Apportionment, see note 20, at 13.
31. Id. at 14.
32. California AB55, 1981-82 Regular Sess. (1980).
33. Id.
34. Unitary Method of Apportionment, see note 20, at 31.
35. California AB765, 1981-82 Regular Sess. (1981).
36. Unitary Method of Apportionment, see note 20, at 31.
37. California AB1238, 1981-82 Regular Sess. (1981).
38. Id.
39. Unitary Method of Apportionment, see note 20, at 31.
40. Illinois HB2588, 82nd General Assembly (1982).

Thompson appointed a task force to study the impact of the bill and to recommend whether or not the bill should be signed by the Governor.

Pursuant to Art. IV, Sec. 9(e) of the Illinois Constitution, the Governor has the power to amendatorially veto legislation.[41] If the amendatory veto option is elected, the governor sends the bill back to the legislature with specific recommendations for change. The legislature can endorse the changes with a simple majority vote or may override the veto with a three-fifths vote.

Governor Thompson amendatorially vetoed HB2588 on 20 September 1982 and returned it to the Illinois legislature with the following recommendations:

(1) The Illinois statutes should clearly define a unitary group as one in which the members are in the same line of business, are on the same apportionment formula, and are functionally integrated.
(2) World-wide unitary reporting should be rejected. The bill would require combined reporting of the domestic members of a unitary group (including foreign-owned taxpayers).
(3) Dividends from foreign subsidiaries should be treated in the same manner as dividends from domestic subsidiaries.
(4) Sales of tangible personal property between domestic and foreign members of a unitary group should be treated in the same manner as intercompany sales between domestic members of a unitary business.[42]

The Illinois legislature, in a lame duck session, endorsed the changes, and Governor Thompson certified the legislation on 15 December 1982.

CONCLUSION

No further federal or state legislative action is likely to occur until after the United States Supreme Court decides the *Container Corporation of America* and *Caterpillar Tractor Co.* cases. (It should be noted that even if the United States Supreme Court holds the unitary tax method to be constitutional, the Supreme Court will not rule on the applicability of the unitary tax to a foreign parent corporation, as this issue is not presently before the Court.)

Assuming that the United States Supreme Court does not hold that the unitary method of taxation is unconstitutional as a matter of law, the unitary method of computing tax will remain in force in appropriate circumstances. Therefore, if the unitary method is to be abolished or severely limited, it will be up to the United States Congress or the state legislatures to enact corrective legislation.

In order to provide a uniform result throughout the nation, it is highly desirable that legislation be enacted by the United States Congress. Legislation such as S.655 and H.R.1983 will provide a significant amount of tax relief to companies engaged in multinational operations.

If the Congress is not willing to act, then it will be the responsibility of each state which utilizes the unitary method of taxation to be certain that the law is applied fairly to multinational businesses. For example, if the California Franchise Tax Board properly applies Sec. 25137 of the Revenue and Taxation Code in appropriate situations, then corrective legislation in California may not be necessary. However, if the Franchise Tax Board continues its current policy of essentially ignoring Sec. 25137, the California legislature should enact legislation to abolish world-wide combined reporting. Perhaps the recently enacted Illinois legislation will serve as a model to other states, in the absence of federal legislation.

41. Letter from Illinois Governor, see note 8.
42. Id.

Unitary Taxation: An International Approach

By Dr. H.A. Kogels

First of all I would like to emphasize that I shall deal with the international aspects of unitary taxation. This means I shall keep away from the question whether the unitary principle should or should not be the leading principle for taxing multi-state business within the U.S. For the purpose of this Dutch/U.S. meeting of the International Fiscal Association I shall restrict myself to the question whether unitary taxation as applied by a number of states of the U.S. would conflict with principles of international taxation that should apply between the U.S. and foreign nations. I shall focus this question on foreign parent companies with subsidiaries located in the U.S. Related questions concerning the constitutional aspects of the application of combined reporting and issues of foreign commerce and foreign policy are not dealt with. For these questions I may refer to appellant's brief and the brief of the Union of Industries of the European Community (UNICE) as amicus curiae in the Chicago Bridge & Iron Company versus Caterpillar Tractor Company, Illinois Department of Revenue et al. case.[1] In this paper I shall work out briefly five basic features regarding international problems of unitary taxation.

(1) The separate accounting or arm's length principle is internationally accepted as the best principle for the international allocation of income in accordance with the tax sovereignty of states like the U.S. and the Netherlands. Unitary taxation, when applied beyond a homogeneous economy like the U.S., distorts the international allocation of income in violation of the principles of tax treaties and thus results in international double taxation.

(2) As regards the arm's length principle – laid down in the tax conventions of the U.S. – political subdivisions or tax authorities at a non-federal level should adopt this universally accepted principle in order to avoid incurable double taxation as a result of unitary taxation.

(3) Unitary taxation imposed on a foreign parent creates far more burdensome tax obligations than those imposed on domestic companies, which is in violation of the tax treaties.

(4) Unitary taxation and the requirement of world-wide reporting of income have a direct and adverse impact on foreign parents, and other members of a multinational group abroad, with subsidiaries in the U.S.

(5) As regards this impact of unitary taxation, it discourages foreign companies from investing in those states. So the application of the unitary principle not only leads to an increase of tax revenues but also to a decrease of job opportunities for the state concerned. Moreover, persistence by certain states along this course could cause other nations to consider retaliatory taxation on foreign subsidiaries of U.S corporations.

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Unitary taxation leads to international double taxation

The unitary tax method, applied on a world-wide combination basis, may result in international double taxation. This means that foreign income of foreign corporations which is in principle not subject to U.S. federal income tax is nevertheless concurrently taxed by one or more states of the U.S. and by foreign countries.

In general, foreign-source income of foreign corporations is not subject to federal income tax but is fully taxed abroad in accordance with the international arm's length, separate accounting principle. If a state effectively taxes income arising abroad it should at least allow an offsetting credit for the foreign tax on this foreign income to avoid international double taxation. In a letter to the California Franchise Tax Board, Mr. Michael Blumenthal said that the use of another method than the internationally accepted arm's length standard will often lead to international double taxation.[2] In the Memorandum for the U.S. as amicus curiae, filed in the Chicago Bridge & Iron versus Caterpillar Tractor case, we also can read that using the unitary apportionment method the state (of Illinois) frustrates the federal policy, consistent with international usage, of avoiding or mitigating international double taxation.

The international income tax treaty network is based upon the principle of avoiding international double taxation. Although two countries may differ as to the nature and the amount of the adequate adjustments to reach arm's length relationships among affiliated corporations, the tax treaties provide the mechanisms for revolving such disputes and eliminating or mitigating double taxation. World-wide combined reporting does not fit in the international tax system, the more so when it is required of a subsidiary of a foreign parent company. Therefore it is not acceptable for a tax administration to argue that some may win and some may lose: some taxpayers may suffer double taxation whilst others may be better off than when separate accounting is applied. Any overlap of taxes constitutes legal and economic double taxation. I may refer to the Supreme Court of the U.S. in Japan Line versus County of Los Angeles, stating: "even a slight overlapping of tax – a problem that might be deemed de minimis in a domestic context – assumes importance where sensitive matters of foreign relations and national sovereignty are concerned".[3]

1. Supreme Court of the U.S., October Term 1981, No. 81-349.
2. Hearings before the Senate Committee on Foreign Relations, 95th Congress, 1st Sess. (1977) ("Hearings"), P. 412.
3. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).

Examples of double taxation as a result of unitary taxation

In the response of the Unitary Tax Campaign Ltd. (a club of British crusaders against unitary taxation) to the U.S. Treasury questionnaire on unitary taxation, we find some striking examples of specific instances where U.S. subsidiary corporations suffer a serious burden of international double taxation.

(1) A U.S./Dutch example: Lever Brothers Company is a member of the Unilever Group of Dutch and English companies. From 1967 through 1973 the California Tax Board applied the unitary method combining the world-wide income of Unilever NV. Over this period, Lever Brothers did not suffer losses. In 1968 the arm's length income reported for federal purposes was $2,378,000 but the taxable income recomputed by the California Tax Board was $4,664,517.78. The 7% California tax resulted in an effective California tax rate of 13.7%. In 1973 the recomputed income was taxed at an effective rate of 40.2%. Although the average California statutory tax rate over these years was 7.27%, the average effective tax rate was almost 3 times this rate: 20.99%.

(2) Another example: Scallop Nuclear Inc. (a subsidiary of the Royal Dutch/Shell Group – Netherlands and United Kingdom parents), which suffered over a 4-year period a loss of nearly $275 million for federal purposes, was subject to California tax on an income of approximately $46 million over this period, because California combined Scallop with more than 900 world-wide members of the Royal Dutch/Shell group. This resulted in an infinitely large effective state tax rate.[4]

(3) Alcan Aluminium Limited (a Canadian parent corporation with foreign affiliates) was taxed by California through its U.S. subsidiary. Combining the world-wide income of the group California converted a $140,000 federal tax loss into over $102 million income subject to formulary apportionment.[5]

Unitary principle versus arm's length principle

It is not by accident that the separate accounting or arm's length principle has achieved international acceptance. It is in accordance with basic principles of tax sovereignty. These start from the principle that a state is entitled to tax the income which has its source within the territory of that state. This makes the separate accounting principle the yardstick for international income allocation for tax purposes. Looking to unitary taxation the following questions arise:

(a) Is the formulary apportionment method in accordance with the arm's length method? As the three-factor formula – as used by the states requiring world-wide combined reporting – can create distortions by allocating foreign income to these states and away from the source country, it is not in accordance with the arm's length principle.

(b) Why does formulary apportionment lead to an incorrect (distorted) attribution of income between internationally affiliated companies? The three-factor apportionment is based on the (simplifying) assumption that each dollar invested in property and payroll and each dollar received through sales represents a roughly equal contribution to the overall net income of the business. Apart from the question whether this assumption may be valid in interstate relationships, it is not valid (or is at least doubtful) in international business practice. The circumstances under which a multinational group of companies operates in various countries are frequently not comparable. Sales factors, wage rates, productivity, currency fluctuations and other risks have different influences in various countries. The application of a world-wide apportionment formula based upon the false assumptions that business, economic and political conditions and circumstances throughout the world are identical to the U.S. situation leads necessarily to a false and erroneous result.

(c) Is it administratively impossible to enforce the arm's length standard and thus – as some states assert – necessary to apply apportionment? I must say this appears to me a sophism. In the first place many multinational companies really try to adhere to this standard in their transfer pricing systems and tax returns. For most companies, discussions with tax authorities are only related to fringe situations. Furthermore, using the arm's length method the states can rely on and make use of the results of federal audit determinations. Arm's length can be difficult, of course, but is is exaggerated to assert that it is impossible to reach an international allocation of income for tax purposes. Furthermore a special – and possibly as complex – auditing system for combined reporting means an extra administrative burden for the state tax authorities as well as for the multinational group as a whole.

The arm's length principle as a yardstick for apportionment methods admitted by the OECD

In the context of the attribution of profits to a permanent establishment, the OECD Draft Convention (Article 7(4)) admits an attribution of profits on the basis of apportionment. But it is stipulated that: "the method of apportionment adopted shall . . . be such that the result shall be in accordance with the principles contained in this article". In the commentary on Article 7, it is considered that an apportionment method is generally not as appropriate as a method based on the principle of separate accounting. For insurance enterprises or banking and financial concerns the use of apportionment by reference to premiums and working capital, respectively, may be appropriate for the attribution of profits to their permanent establishments. The commentary continues by stating that the general aim of any method involving apportionment of total profits ought to lead to a taxable profit that approximates as closely as possible to a taxable profit calculated on a separate accounting basis. In other words, the OECD confirms the primacy of the

4. Shell Petroleum N.V. v. Graves, No. C 81-4302 (as referred to in the Unitary Tax Campaign responses to the U.S. Treasury questionnaire).
5. Alcan Aluminium Ltd. v. Franchise Tax Board of California, No. 81-3911 (as referred to in the Unitary Tax Campaign responses to the U.S. Treasury questionnaire).

arm's length principle by making it the yardstick for any apportionment system admitted by this article of the OECD Draft Convention. Furthermore, the commentary on this article says it is the responsibility of the taxation authority, in consultation with the authorities of the other country (or countries) concerned, to use the apportionment method which, in the light of all the known facts, seems most likely to reach the arm's length result.

The situation cannot arise of course, but it is interesting to speculate, for example, on the state of California setting up a consultation with the Dutch national tax authority to work out such an apportionment method. I fail to see how the consultation could lead to anything but separate accounting itself; the apportionment method applied by California would never qualify as approximating separate accounting as closely as possible.

Record keeping in relation to unitary taxation

All over the world we find divergent concepts of financial reporting. Moreover in most countries taxation reporting diverges from financial reporting.[6] Foreign parent corporations and their non-U.S. subsidiaries or affiliated companies have no need to keep records based on U.S. tax principles. This situation is a result of the separate accounting, arm's length principle: foreign corporations are not subject to U.S. tax on their non-U.S. foreign-source income. But when a state uses world-wide combined reporting this requires a conversion to U.S. principles and thus two different sets of books. This extra administrative burden is not limited to the parent corporation only, but extends over the whole multinational group of corporations: as we have seen before in the Scallop case, over more than 900 companies! Furthermore, in converting the records to U.S. tax principles, the states require translation of the foreign currency into dollars. This is difficult if not impossible depending on the extent of the multinational group and the period over which the conversion has to be made. The overwhelming record keeping burden can be shown from the following example.

Lever Brothers Company, a member of the Dutch Unilever N.V. Group, had to follow three steps in order to meet the California requirements of combined reporting: *first*, convert world-wide income determined under different foreign financial accounting standards into income determined under U.S. financial *accounting standards; second*, the U.S. financial income is adjusted to accommodate differences between U.S. financial and *federal tax accounting standards; third,* federal taxable income is adjusted to take into account any differences between federal and *state tax accounting rules*.

Supply of information

As I have explained, the apportionment method requires rather detailed information about business activities of foreign members of the group. Sometimes a state agency needs information a foreign corporation cannot supply without committing a crime in its home country. The California Franchise Tax Board, auditing EMI Limited, required information British and Australian members of the group could not supply without violating U.K. and Australian secrecy laws. Their refusal to give this information concerning defense matters resulted in an assessment of California tax based upon estimates which are incorrect but not refutable by EMI. The application of the arm's length method does not require such disclosure of information of this nature.[7]

As regards increased information requirements the apportionment method leads to a "catch 22" situation. Through higher demands on information, states can manipulate the revenues from their taxes based on the apportionment method. Where the regular financial statements of the foreign parent result in a higher tax revenue than would be the case with more specific and accurate information, the foreign company has no other way to reduce its state tax burden than by generating additional, more specific and more accurate information. On the other hand, where regular financial statements do not lead to a satisfying tax revenue for the state the tax authorities frequently demand burdensome additional information.

Not all the states using the unitary method apply it in as aggressive a manner as California, for example, but it is tempting to use world-wide combined reporting in order to raise state tax revenues. Therefore it is clear that the states using the unitary method strongly oppose the pending Conable/Mathias bills (HR 1983 and S 655) with the argument of a substantial loss of revenues.[8] However, as we have seen before, the internationally accepted separate accounting principle does not permit a state to tax income of the foreign parent company which may not be attributed to the U.S. subsidiary in accordance with arm's length dealing. In other words, I am of the opinion that the states' argument concerns a loss of revenue that should not accrue to them in the first place; that is, if they properly restricted their tax object to income arising within the state.

The impact on foreign investment in the U.S.

Considering the examples of double taxation I just mentioned, it is quite obvious that the application of the unitary tax method to internationally affiliated companies discourages foreign investment in the U.S. In several hearings this aspect of unitary taxation has been mentioned, not only by representatives of various foreign corporations but also by Mr. Blumenthal, secretary of the U.S. Treasury, and his assistant Mr. Woodworth, Senator Hayakawa, Governor Edmund Brown Jr. and Senator Cranston.[9] Not only the high effective tax rates

6. Draft Report on the relationship between Taxation and Financial Reporting, Working Group on Accounting Standards of the OECD, February 1982.
7. EMI Ltd. v. William M. Bennet et al., No. 80-4114 (as referred to in the Unitary Tax Campaign responses to the U.S. Treasury questionnaire).
8. *Tax Notes,* 4 January 1982, Volume I, p. 9.
9. See footnote 2 and e.g. Hearings on S 983 and S 1688 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, 96th Congress, 2nd. Sess. (24 June 1980).

– sometimes infinitely high as we have seen – as a result of international double taxation but also the burden of information required for a combined report discourage foreign investment in the U.S. There is a perceptible tendency for foreign corporations to seriously consider relocation in states which do not make any attempts to introduce the combined reporting method. Other companies do not even take the risk of being subject to unitary taxation and avoid the U.S. when considering the establishment of a subsidiary.

According to the Multistate Tax Commission, the Conable/Mathias bills (HR 1983 and S 655) limiting the unitary tax method would cost 33 states of the U.S. over $700 million this year and billions of dollars in the future. I cannot judge whether this amount relates only to the elimination of the international double taxation mentioned in this paper. However, I will not deny the budgetary problems between the Federal Government and these states as a result of this pending legislation. Apart from the basic question regarding the incompatibility of the unitary method with the internationally accepted arm's length principle, I am of the opinion that these budgetary problems should be set off against the discouraging effects of unitary taxation on foreign investors and the effect on job opportunities in these states as a result of this discouragement.

Final remarks

In his address to the guests and members of the International Fiscal Association on the occasion of the Copenhagen Congress 1979, IFA president Alun Davies called unitary taxation a tax animal which "has come up from the tax sewers, feeds on state greed and needs a few knights in shining armour to go forth and destroy it, before it does untold damage".

Meanwhile the discussion on unitary taxation is going on. Legislation has been proposed limiting state use of the unitary apportionment method and restricting state taxation of foreign-source income (HR 5076 and S 1688, later replaced by HR 1983 and S 655). And there is more than that. There is a growing discussion about the phenomenon of world-wide combination reporting based on the unitary principle, not only in tax literature but also in official statements and amicus letters in the cases before the State Supreme Courts and the Supreme Court of the U.S. By circulating two questionnaires the U.S. Treasury has tried to gather information to form its policy position on the unitary tax method, especially regarding the international aspects of this method. I am speaking as a Dutch fiscal economist but also speaking with the voice of the Federation of Netherlands Industry when I say it is well known that the Netherlands accounts for almost one third of direct foreign investment in the U.S. Therefore I plead against the world-wide application of unitary taxation. For the sake of both our countries.

AUSTRALIAN TAXATION RESEARCH FOUNDATION

On 9 December 1982 the following statement was made by Sir Hermann Black, Chairman of the Australian Tax Research Foundation

A highly-professional independent Foundation has been established to help achieve fundamental, non-political reforms in Australia's taxation system.

This major breakthrough in the taxation area has the support of both the Federal Treasurer, Hon. J. Howard, and the Leader of the Opposition, Mr. W. Hayden.

The Australian Tax Research Foundation has been formed by the four (4) professional bodies in the accountancy, legal and taxation fields – the Law Council of Australia, the Taxation Institute of Australia, the Institute of Chartered Accountants in Australia and the Australian Society of Accountants.

A basic objective is to provide a source of completely unbiased research for governments and others concerned with taxation reform.

The Foundation hopes to encourage the replacement of adhoc piecemeal attempts to change the taxation "system" with consistent, commonsense and scientific approaches to tax reform.

Among the wide range of subjects to be tackled in 1983 are:
* Taxation issues of the 1980's;
* Inequities under the present system;
* Avoidance and evasion;
* Taxation and inflation;
* The capital gains taxes question;
* Implications of indirect taxation.

The Foundation recognises the need for changes in the Australian taxation system and the inequities and anomalies which exist in a number of areas and which can create divisiveness in our society.

It believes, however, that changes in direction should only be made after careful, objective and thorough study of the issues involved.

The Foundation plans to thoroughly explore these issues and to highlight inequities and anomalies with a view to identifying acceptable alternatives.

Its strength will lie in its independence from party politics and from vested interests.

The Foundation hopes that because of this and the expertise which it will marshal, its assistance will be sought on taxation issues by Government and Opposition as well as by all groups with a major interest in taxation.

In addition to conducting research, the Foundation will speak with an authoritative voice on major Federal and State taxation issues.

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UNITED STATES

The Operation and Effect of the Domestic International Sales Corporation Legislation

Report released by the Treasury on 27 December 1982 covering 1980 DISC operations

CHAPTER 1
INTRODUCTION AND SUMMARY

This report is the ninth in an annual series on the operation and effect of the domestic international sales corporation (DISC) legislation. A DISC is a special corporation that allows the deferral of income tax on a portion of export profits. The report covers the eighth full year of DISC operations. It presents statistical estimates derived from a sample of tax returns, Form 1120-DISC, filed for accounting periods ending between July 1, 1979 and June 30, 1980, referred to as DISC year 1980.

The scope of DISC activity measured both by export receipts and net income continued to expand in DISC year 1980. DISC exports of manufactured goods increased 28% from DISC year 1979 to $94.1 billion. Net income attributable to DISC manufactured exports rose 30% to $7.7 billion in DISC year 1980.

Chapter 2 discusses the 1971 DISC legislation and the modifications to the original legislation in the Tax Reduction Act of 1975 and in the Tax Reform Act of 1976, which restricted DISC benefits to increased, rather than total, export sales.

Chapter 3 discusses the impact of the DISC legislation on U.S. exports. The extent to which DISC increased U.S. exports in DISC year 1980 over what they would otherwise have been, is estimated to range between $6.2 billion and $9.4 billion. This represents an increase of approximately 36% over DISC year 1979. The range is based on a consideration of the conditions of demand and supply in various product categories. DISC tax savings increase the profitability of exports and, therefore, stimulate an additional supply of exports. The extent to which export supply is stimulated depends on the responsiveness of supply to the change in the profitability of capital used for export production.

Beginning in DISC year 1981 the export incentive effect of DISC will be reduced by the Accelerated Cost Recovery System (ACRS), which was introduced in the Economic Recovery Tax Act of 1981 (ERTA). ACRS increases the after-tax return on capital overall by reducing taxable income. The effect of ACRS, therefore, is to reduce the relative differential conveyed by DISC with respect to the after-tax return on capital. By the same token, ACRS reduces the incentive of DISC for production for export relative to production for the domestic market.

As is shown in Chapter 4, the revenue cost of DISC in DISC year 1980 was $1,410 million, assuming a marginal tax rate of 46%. This amounted to a 42% increase over DISC year 1979. The increases in the export effect and revenue cost of DISC reflect the growth in U.S. exports, the growing DISC share of total exports, and the larger percentage of DISC profits that could be deferred in DISC year 1980.

Assuming the statutory corporate rate of 46% in making the revenue estimates ignores the effect of net operating losses and excess tax credits, which may significantly reduce the marginal tax rate on tax-deferred income. If there are substantial net operating losses and excess tax credits that cannot be carried forward in the absence of DISC, the revenue cost of DISC would be significantly less than the estimated values. However, the export impact of DISC would also be reduced in approximate proportion to the reduction in the revenue cost.

Summary income and balance sheet statistics derived from DISC returns are presented in Chapter 5. The consolidated profit margin earned on DISC exports of manufactured goods decreased from 14.1% in DISC year 1979 to 13.9% in DISC year 1980. Tax deferred income was 19.3% of the consolidated income from manufactured exports by DISCs. Net income reported by all DISCs was $8.4 billion. Transportation equipment, non-electrical machinery, and chemicals – in that order – accounted for the largest dollar amounts of DISC income.

CHAPTER 2
HISTORY AND PROVISIONS OF DISC STATUTE

Provisions of the original DISC legislation

Title V of the Revenue Act of 1971 provided for the creation of Domestic International Sales Corporations (DISCs). Its objective was to stimulate an increase in exports by lowering the effective rate of taxation of export income. The legislation provided a tax deferral for part of the export income channeled through a DISC. A DISC is exempt from federal income tax, but its shareholders are taxable on dividends distributed or deemed distributed by a DISC. Until 1976, the shareholders of a DISC were generally deemed to receive an annual dividend equal to one half of the DISC's taxable income, even if the DISC distributed less. This deemed distribution was fully taxable to the shareholders. Federal income tax could be deferred on the remaining half of the DISC's taxable income, until the income was actually distributed to the DISC shareholders, a shareholder disposed of the DISC stock, the DISC was liquidated, the corporation ceased to qualify as a DISC, or the DISC election was terminated or revoked by the shareholder(s).

To qualify for tax exemption, a DISC must be incorporated under the laws of any state or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the "gross receipts" and "gross assets" tests.

The gross receipts test requires that at least 95% of the corporation's gross receipts consist of "qualified export receipts". In general, qualified export receipts are to be derived from the sale or lease for use outside the United States of "export property", or from the furnishing of services related and subsidiary to the sale or lease of export property. Also included are dividends on stock of a "related foreign export corporation" and interest on any obligation which was a "qualified export asset". "Export property" is defined as property manufactured, produced, grown, or extracted in the United States. Exports subsidized by the U.S. Government or exports intended for use in the United States do not qualify as export property. A DISC may not engage in producing, growing, or manufacturing export property.

The gross assets test requires that at least 95% of the corporation's assets be qualified export assets. In general, qualified export assets include inventories of export property, necessary operational equipment and supplies, trade receivables from export sales (including commissions receivable), producer's loans, working capital, investments in related foreign export corporations, obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association, and obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank.

If a DISC fails to meet either the gross receipts or gross assets test, it may continue to qualify as a DISC by making a pro-rata distribution to its shareholders equal to the portion of the income attributable to the ineligible receipts or equal to the fair market value of the unqualified assets, depending on the nature of the disqualification. However, if a DISC is disqualified, or otherwise terminates its status as a DISC, the deferred tax becomes payable over a period of time.

A DISC usually acquires export property from its parent corporation or an affiliated corporation ("related supplier") and then sells the property abroad; however, it can act simply as a commission agent. In many cases, a DISC is a "paper" corporation without any employees or real operations. The method used for allocating income between a DISC and its related suppliers therefore is an important part of the DISC statute. The allocation is achieved through special intercompany pricing rules which permit the DISC to realize taxable income in an amount which does not exceed the greater of:

(a) 4% of the qualified export receipts attributable to the sale of export property plus 10% of related "export promotion expenses", defined as ordinary and necessary expenses incurred to obtain qualified export receipts (referred to as the 4% method);

(b) 50% of the combined taxable income of the DISC and its related supplier attributable to qualified export receipts plus 10% of related "export promotion expenses" (referred to as the 50-50 method);

(c) taxable income based upon the price actually charged the DISC by its related supplier if that price is justifiable on an arm's-length basis (referred to as the arm's-length method).

Under marginal costing rules, if the 50-50 method is used by the DISC, only the marginal or variable production and sales costs for the export property need be included in the computation of combined taxable income. In general, the benefits of marginal cost pricing are limited, however, to instances where the variable cost margin on the DISC's export sales of a product is less than the full cost margin on the combined sales of the product by the DISC and the related supplier. Neither the 4% method nor the 50-50 method can be applied in such a way as to cause a loss to the related supplier while the DISC is earning a net profit. These special intercompany pricing rules allow exporters to allocate more income to a DISC, and thus to defer a larger portion of their total tax burden, than they would be able to under the normal arm's-length rule.

Statutory amendments

The Tax Reform Act of 1975 denied DISC benefits to profits arising from exports of products in short domestic supply, as determined by the Commerce Department under the Export Administration Act of 1969 or by Executive Order of the President. The Act also removed DISC benefits from exports of natural resource products, such as oil, gas, and minerals, subject to a percentage depletion allowance. The Tax Reform Act of 1976, excluded renewable resources, such as timber, from the natural resource products ineligible for DISC benefits.

The Tax Reduction Act of 1976 included the incremental provisions, effective for accounting periods, beginning after December 31, 1975. Under these provisions, DISC benefits (deferral of tax on one half of profits) are limited to income attributable to export gross receipts in excess of 67% of average export gross receipts in a 4-year base period. For taxable years beginning in 1976 through 1979, the base period years are 1972 through 1975. Starting with taxable years beginning in 1980, the base period is advanced each year. For example, the base period is 1973 through 1976 for taxable years beginning in 1980, and 1974 through 1977 for taxable years beginning in 1981.[1] DISCs with adjusted taxable income of $100,000 or less are exempt from the incremental rule. This exemption is phased out as ajusted taxable income increases from $100,000 to $150,000.

In applying the incremental rule, a DISC's export gross receipts are treated as equal to zero for those base period years in which the DISC did not exist. In order to prevent a controlling shareholder from gaining an advantage by shifting exports from one DISC to another, the sales of all DISCs that are part of a controlled group are combined in calculating base-period exports. Appropriate allowance is made for base-period sales of products no longer fully eligible for DISC benefits, such as natural resource products.

The incremental provisions enacted in 1976 reduced DISC benefits for eligible export products initially by about 40% for taxable years beginning after December 31, 1975.[2]

The 1976 Act made additional amendments to the DISC legislation. The most important of these was to reduce the DISC deferral on sales of military goods to one half the amount which would otherwise be allowed. The 1976 Act also lengthened the period for recapture of the deferred tax, in the event of disqualification or termination of DISC status, to twice the number of years of the DISC's existence, up to a maximum period of 10 years.

The Tax Equity and Fiscal Responsibility Act of 1982 increased the deemed distribution by a DISC to a corporate shareholder from 50% to 57.5% of taxable income. The provision, which reduces DISC benefits for such shareholders by 15%, applies for tax years beginning after 1982.

CHAPTER 3

THE EFFECT OF DISC ON THE LEVEL AND STRUCTURE OF U.S. TRADE

As in last year's report, this report offers a range of estimates of the impact of DISC on exports based on assumed responses to increased supplies made possible by DISC. Until last year, the reports compared the growth in DISC and non-DISC exports and presented a specific estimate of the impact of DISC on exports. This DISC/Non-DISC comparison is no longer used because of the limitations explained in Appendix B of the 1979 report.

Any analysis of the impact of DISC on exports must be done against the background of the $138 billion growth in exports that occurred between 1971 and 1979. While U.S. exports increased substantially, the U.S. share of free world exports of manufactures declined from 19.7% in 1971 to 17.4% in 1979.[3] DISC exports of manufactured goods as a share of total U.S exports of manufactured goods, however, rose from 65.7% in DISC year 1979 to 66.7% in DISC year 1980.[4]

DISC increases the profitability of exporting and therefore stimulates an increase in export supply by U.S. producers. Labor and capital are drawn into the export sector. The extent to which a reduction in costs or an increase in price induces the expanded production of exports is indicated by the price elasticity of supply. The stimulating effect of DISC on exports therefore depends on supply and demand responses, combined with the shift in export supply brought about by DISC.

The impact of DISC on exports is estimated by first classifying the specific products listed in Table 3-1 into four categories with differing supply and demand behavior. The responsiveness of export supply is generally assumed to be very high. One reason is that output can easily be diverted from domestic demand, which for most goods is much larger than export demand. If the return from diverting output is positive, the destination of sales will change until the return from selling in either market is identical. Furthermore, many goods are produced with standard, widely diffused technologies so that labor and capital can easily be shifted from other uses in order to expand output. Demand is also highly responsive where standardized commodities are sold in many markets, as in the case of farm products. The responsiveness of demand is somewhat lower in cases in which products are more differentiated, or have to be adapted to particular markets.

The four categories into which products are classified are:

1. Non-manufactured products (mainly agricultural commodities). These are products whose demand is very highly responsive to price changes because identical products are supplied and demanded by many countries. For example, grains are sold in standard grades in many markets. The elasticity of export supply is a function of the elasticities of domestic demand and supply and the proportion of U.S. output that is already exported. The smaller the domestic demand and supply elasticities and the larger the proportion of U.S. production going to export, the smaller the export elasticity of supply. These three factors combine to make the export elasticity of supply of agricultural commodities not as high as the export supply elasticity in manufacturing.

2. Basic manufacturing industries not requiring advanced technology. These products

1. For an analysis of the effect of the incremental provision on the incentive to expand exports, see the 1976 Report, pages 15-16 and 53-58. It is demonstrated there that, for the same increase in tax revenue, an across-the-board reduction in the DISC deferral rate might have had a slightly more favorable impact on the incentive to expand exports than the more complicated 1976 provision does.

2. The amount of the reduction is estimated by comparing the ratios, for periods, before and after the 1976 Act was effective, of DISCs' tax-deferred income to net income. Statistics in the 1977 and 1978 Reports indicate that this ratio was .49 in the last full year before the Act came into effect, and .29 in the first full year to which the Act applied (the last part of DISC year 1977 and the first part of DISC year 1978). The ratio of tax-deferred income to net income increased to .32 in DISC year 1979 and to .36 in DISC year 1980 because the base period remained unchanged.

3. All aggregate trade data are taken from the quarterly publication of the U.S. Department of Commerce, *International Economic Indicators*.

4. Statistics on DISC exports of non-manufactured products, specifically agricultural products, exceed actual U.S. exports from all sources by a substantial margin because of sales between unrelated DISCs. That is to say, one DISC may sell to another DISC. As long as the property sold is ultimately for direct use, consumption, or sale outside the United States, its sale is a qualified export receipt. Therefore, comparisons between DISC exports and total U.S. exports of agricultural products do not lead to any meaningful comparisons. Inter-DISC sales may also add some error to the statistics on manufactured exports.

include textiles, rubber, fabricated metal products, and transportation equipment other than aircraft. The elasticity of supply is high because products tend to be relatively standardized in most world markets; hence little change in these products is required to adapt them to export, compared with domestic, markets. Moreover, since these products use relatively standard technologies, capital and labor can easily be adapted to expanded production. Since these products are so little differentiated, their elasticity of demand is also quite high.

3. High technology manufactured products. Examples include chemicals, aircraft, electrical machinery and equipment, and office machinery. It is assumed that demand is somewhat less elastic than category 2. Products are also more likely to be differentiated, which would also reduce the elasticity of demand. The high technological level reduces the number of countries that may be alternative sources of supply.

4. Resource-related manufacturing products. These include paper, lumber, and nonferrous metals. Production of these products is constrained by the availability of some natural resources in the United States. Products tend to be standardized. This category is therefore close in character to non-manufactured products in having both very elastic supply and demand conditions.

The particular products in each category are listed in Appendix B (not reproduced here). Appendix B also gives the elasticities of demand and supply assumed for each category.

Figure 1 illustrates the analysis in this chapter of the change in exports that would occur if DISC were eliminated. The example depicted is for an export such as an agricultural good with a very high demand elasticity. DD and SS are the current demand and supply schedules respectively. The current level of exports is OX and the price is XA. The elimination of DISC decreases export supply, i.e. shifts the supply of export schedule upwards to S'S' because it reduces the after-tax profit from producing any level of exports. If a price of XA were required, with DISC, to induce producers to produce OX of exports, then without DISC, a price of XB would be needed. But since that price cannot be obtained with the demand represented by DD, OX of exports will not be supplied.

The magnitude of BA, the vertical shift in the supply schedule, depends on the DISC tax saving per dollar of capital devoted to producing exports. Exporters would be willing to continue to supply OX if they could earn the same after-tax profit per unit of such capital. The DISC tax saving per unit of capital is approximated by the reduction in tax on the pretax return per unit of capital used. This reduction depends on the percentage of profits that can be deferred and the marginal corporate tax rate, which is assumed to be 46% for DISC year 1980.

As a result of the shift in supply resulting from the elimination of DISC, exports fall to OY. More generally, the magnitude of the changes in the quantity of exports depends on the slopes of the demand and supply schedules in each category.

The analysis of the reduction in the value of exports if DISC were eliminated is sum-

Table 3-1

Gross receipts, net income and tax-deferred income by major product class[1] – DISC year 1980
(Dollar amounts in millions)

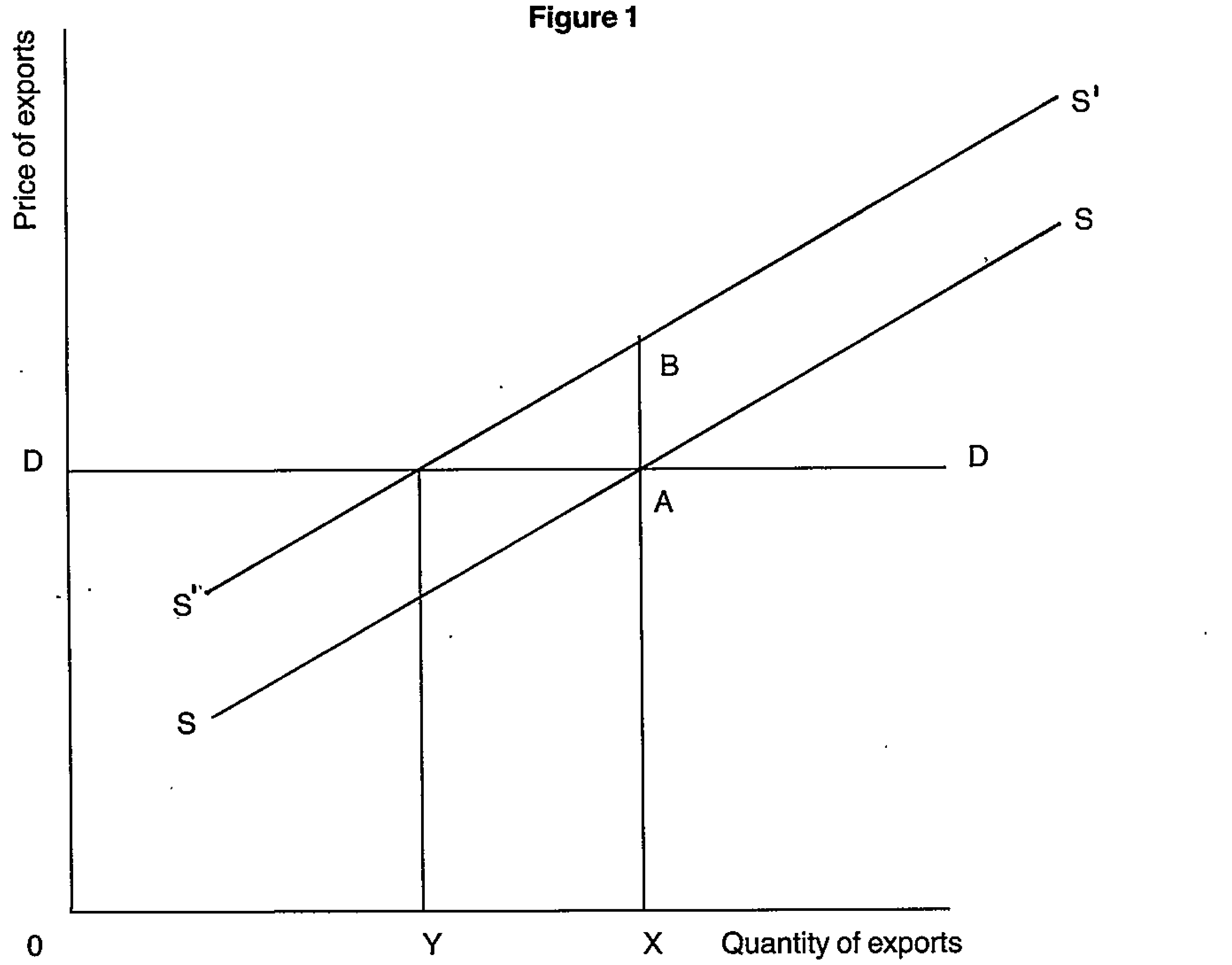
Major product class	*Number of returns*	*Gross receipts*	*Net income*	*Tax-deferred income*	*Deferred tax as a percent of gross receipts* [3]
TOTAL	7,933	131,976	8,426.5	3,065.9	1.1
Non-manufactured products	953	37,867	728.1	284.4	0.3
Agricultural products	302	35,731	520.8	205.7	0.3
Grains	119	32,816	445.5	178.4	0.3
Other agricultural products	183	2,915	75.3	27.3	0.4
Mineral products	58	819	35.9	16.6	0.9
Other	593	1,317	171.4	62.1	2.2
Manufactured products [2]	6,980	94,109	7,698.4	2,781.5	1.4
Ordnance	22	195	22.5	5.5	1.3
Food and kindred products	273	3,207	179.5	66.5	1.0
Meat products	77	936	47.3	18.1	0.9
Canned fruits, vegetables, seafood	56	699	43.6	17.7	1.2
Grain mill products	30	519	31.7	9.9	0.9
Tobacco manufactures	12	903	79.0	30.7	1.6
Textile mill products	247	1,629	96.8	38.2	1.1
Apparel, etc.	151	359	19.8	7.0	0.9
Lumber, etc., except furniture	197	2,981	98.3	36.5	0.6
Saw and planing mill products, logging	46	1,481	33.4	12.7	0.4
Millwork, veneer, etc.	60	359	13.5	5.0	0.6
Furniture and fixtures	28	46	4.7	2.1	2.1
Paper and allied products	141	2,029	163.0	49.9	1.1
Printing, publishing, etc.	96	300	35.8	13.1	2.0
Chemicals and allied products	521	13,272	1,318.8	486.1	1.7
Inorganic, organic chemicals	85	5,716	669.7	247.5	2.0
Plastics materials, etc., including fibers	76	3,436	310.9	119.4	1.6
Drugs	45	642	99.6	32.4	2.3
Agricultural	43	1,483	79.1	25.9	0.8
Rubber and miscellaneous plastic products	136	869	54.8	20.4	1.1
Leather and leather products	84	577	16.9	7.0	0.6
Stone, clay, glass and concrete products	68	898	83.6	32.9	1.7
Primary metal industries	244	2,671	146.1	56.4	1.0
Iron and steel industries	53	801	46.2	14.9	0.9
Fabricated metal products	701	3,625	301.8	118.2	1.5
Cutlery, etc.	80	197	17.9	7.7	1.8
Heating and plumbing	73	150	11.4	4.8	1.5
Structural metal products	81	443	38.0	15.1	1.6
Machinery, except electrical	1,465	20,385	1,693.5	588.3	1.3
Engines and turbines	40	4,546	398.3	127.9	1.3
Farm machinery and equipment	110	1,171	65.1	21.9	0.9
Construction, mining, etc.	273	6,257	411.7	141.3	1.0
Metal working	118	527	48.9	17.2	1.5
Special industry	420	2,838	245.9	93.4	1.5
Office, etc.	49	2,518	303.3	114.1	2.1
Electrical machinery and equipment	1,248	11,436	1,012.0	372.6	1.5
Transmission and distribution equipment	51	1,241	149.5	47.4	1.8
Household appliances	49	592	71.2	25.0	1.9
Communications equipment	130	1,059	135.7	49.0	2.1
Electronic components, etc.	470	4,145	370.1	139.0	1.5
Transportation equipment	401	21,819	1,664.8	582.3	1.2
Motor vehicles and equipment	177	13,016	717.2	254.3	0.9
Aircraft and parts	178	8,243	887.5	303.4	1.7

Major product class	Number of returns	Gross receipts	Net income	Tax-deferred income	Deferred tax as a percent of gross receipts[3]
Prof. and scientific instruments, etc.	420	4,912	550.6	204.0	1.9
Research instruments	95	1,039	108.3	43.5	1.9
Physical measuring instruments	140	973	78.5	30.9	1.5
Surgical, medical, dental, etc.	114	571	57.0	23.9	1.9
Photographic equipment	43	2,157	290.4	100.0	2.1
All other manufactures	525	1,996	156.1	63.8	1.5

Office of the Secretary of the Treasury; Office of Tax Analysis

1. Classification is based on the product or product class accounting for the largest portion of gross receipts.
2. Statistics on DISC sales of agricultural products exceed U.S. exports from all sources by a substantial margin because of inter-DISC sales. Therefore, the ratio of net income to gross receipts understates the profit margin on exports of these products.
3. Tax deferred income X 0.46/Gross receipts.

Figure 1



marized in Table 3-2. The overall reduction in the value of exports is in the range of $6.2 billion to $9.4 billion. The relatively modest reductions of exports of non-manufactured products reflects the small DISC-induced shift in export supply. Exports of both basic and high technology manufactured products decline substantially. Although export demand in high technology products is assumed to be somewhat less price sensitive than basic manufactured products, the decline in exports is substantial because the DISC induced shift in export supply is large.

As noted earlier, the $6.2 billion to $9.4 billion increase in exports because of DISC is based on the assumption that the marginal corporate tax rate on DISC income is 46%, i.e. a dollar of tax-deferred income will save 46 cents in taxes. Whether this assumption is valid depends upon the degree to which parents employing DISCs have net operating losses or excess tax credits that in the absence of DISC cannot be carried forward.

If a firm has a net operating loss that cannot be carried forward, then there is no net tax saving associated with deferring income through a DISC. Whatever the firm gains in tax saving by deferring income it could have equally gained by offsetting the income against the previous years' net operating loss. Similarly, if the firm has excess investment tax credits that cannot be carried forward, there is no net saving through a DISC since the tax saved by deferring income could have as well been saved by use of the excess tax credits. However, if the firm could have carried forward the net operating loss or excess tax credits, then there is a current net tax saving from deferring income through a DISC. Nevertheless, there is a limitation on the ability to carry forward net operating losses and excess tax credits so that in the year in which this limitation is reached there is once again no net tax savings from deferring income through a DISC. Therefore, the marginal corporate tax rate on DISC income may be significantly less than 46% and, correspondingly, the export effect of DISC may be significantly less than the estimated range.

The effect of DISC on exports, described above, is the direct effect before any induced changes in patterns of production and investment. In a departure from previous reports, this report analyzes the indirect effect of DISC solely in terms of changes in resource allocation and relative prices. Previous reports have analyzed the second round effect in terms of the impact of a change in U.S. exports on U.S. imports through changes in U.S. exchange rates. Since U.S. exchange rates are the prices of the U.S. dollar in terms of other countries' currencies, these exchange rates are determined by the supply of and demand for the dollar, which is to a large degree a monetary phenomenon. While DISC has an indirect impact on the supply of and demand for the dollar through the U.S. balance of merchandise trade, international flows of services and capital – both short-term and long-term – have an equal and often more important role in determining U.S. exchange rates. The analysis of the second round effect in this year's report, therefore, focuses on the real economic effects of the DISC legislation.

The change in tax on export profits brought about by DISC causes a shift in U.S. capital and labor toward the production of exports.[5] These resources may come from either industries selling goods produced only at home or from industries producing goods competing with imports. A shift in resources away from industries producing non-traded goods will trend to increase their price relative to other goods and, thus, diminish their domestic consumption. Furthermore, a shift in resources away from import competing industries will tend to increase the level of imports. Nevertheless, any increase in the level of imports that may occur will be more than offset by the increase in exports brought about by DISC.

In the long run the effects of DISC on U.S. trade and production will depend on the response of saving and investment flows to the change in the overall return to capital brought about by DISC. Since DISC reduces the effective marginal tax rate on income from capital used in production for export, the after-tax rate of return on capital will, in general, rise as the result of DISC. To the degree that domestic and foreign investment flows respond to this increased rate of return on investment, the U.S. capital stock will increase, generating further increases in U.S. production and trade as the result of DISC. Thus, the estimated range of $6.2 billion to $9.4 billion for the effect of DISC on exports should be viewed as only a first round estimate. A more

5. There is some possibility that DISC exports displace non-DISC exports, but this effect is not likely to be significant. The circumstances in which exporters cannot use a DISC are very specific, as noted in Chapter 2. A DISC would not be used if the firm is making an overall loss. Mineral products benefitting from a percentage depletion allowance are excluded, as are those not intended for use outside the U.S. The latter would include goods exported for assembly and then reimported. DISC and non-DISC exports are therefore unlikely to be very close substitutes.

Table 3-2

Estimated reduction in exports if DISC were eliminated – DISC year 1980

Product category	DISC saving per dollar of sales (in cents)	Percent reducton in value of exports (range)	Decrease in dollar value of exports (billions)
1. Non-manufactured products	.3	1.0–1.6	.4–.6
2. Basic manufactures	1.1	7.9–10.3	2.8–3.6
3. High technology manufactures	1.6	5.3–9.7	2.5–4.7
4. Resources related manufactures	.9	4.1–4.5	.5
TOTAL	1.1	4.7–7.1	6.2–9.4

Office of the Secretary of the Treasury; Office of Tax Analysis

complete estimate taking into account the second round effects would require an analysis based on a dynamic, general equilibrium model of trade and growth, which is not currently available, rather than the partial equilibrium framework employed in this report.

The effect of DISC on U.S. exports will be further modified by the introduction in the Economic Recovery Tax Act of 1981 (ERTA) of the Accelerated Cost Recovery System (ACRS). Without ACRS, DISC creates a differential in favor of exports by reducing the effective marginal corporate tax rate on production for export and, hence, increasing the after-tax return on capital used in export production. Thus, the differential in the after-tax return in favor of exports falls as the result of ACRS. It is this differential which is the key variable in the allocation of capital between production for the domestic market and production for export. ACRS, therefore, reduces the incentive for export production.

The extent to which ACRS narrows the differential between the after-tax return on capital in general and the after-tax return on export production depends, in part, on the pricing method employed. For companies employing the 50-50 pricing method, the effect of ACRS is to reduce the effective tax rate only on the portion of income that is not already deferred under DISC. Under this method, ACRS will, therefore, reduce the relative export incentive of DISC. While the tax benefit of DISC for companies employing the 4% pricing method is not a function of taxable income but rather of gross sales, use of the 4% method is constrained by the requirement that income may not be allocated to a DISC so as to leave the parent in a loss position. Under ACRS this no-loss constraint will become increasingly binding. Therefore, the effect of ACRS is, in general, to reduce the relative export incentive of DISC.

CHAPTER 4

EFFECT OF DISC ON TAX REVENUES

The revenue cost of DISC in DISC year 1980 was $1,410 million. The revenue cost is estimated by applying the statutory corporate tax rate of 46% to the portion of DISC income on which tax is deferred. The tax-deferred income of a DISC is equal to its taxable income less its deemed distributions. Under the original DISC legislation, the principal deemed distribution was 50% of adjusted taxable income.[6] Thus, the ratio of deemed distributions to DISC taxable income was 51% in DISC year 1976.

For accounting periods beginning after December 31, 1975, DISCs are subject to the incremental provision introduced by the Tax Reform Act of 1976. For these periods, DISC shareholders are deemed to receive, in place of 50% of DISC adjusted taxable income, all adjusted taxable income attributable to base period exports (defined as 67% of the average of the export gross receipts of the DISC during calendar years 1972 through 1975), plus 50% of the excess of total adjusted taxable income over the amount attributable to base period exports.[7] As a result of the incremental provision, as well as other kinds of deemed distributions provided by the Tax Reform Act of 1976, the ratio of deemed distributions to DISC taxable income was nearly 70% for DISC year 1977 and 71% for DISC year 1978.[8] The deemed distribution rate decreased to 67.6% in DISC year 1979 because the base period remained unchanged from 1978, and to 63.6% in DISC year 1980 because the base period changed only for taxable years beginning after 1979. Under the Tax Equity and Fiscal Responsibility Act of 1982 the deemed distribution by a DISC to a corporate shareholder is increased from 50% to 57.5% of taxable income for the taxable years beginning after 1982.

The foregoing revenue estimates assume that the labor and capital producing DISC exports would have the same level of income in the absence of DISC, with the only change being that the full corporate rate would apply to profits. In reality, economic responses may make the true revenue cost different from the $1,410 million estimate. In the absence of DISC, before-tax margins may increase. In that case, the revenue estimate would be understated. On the other hand, there may be responses which reduce the revenue cost of DISC. By reducing the tax on the corporate sector, DISC will increase saving and attract capital from the non-corporate sector. The increased capital stock may lead to higher levels of output, employment, and tax revenue. In the absence of DISC, exporters might have found other ways within existing law to "shelter" export profits. These and other behavioral changes may have an impact on the revenue cost of DISC, but the magnitude of the offset cannot be estimated without more precise information on the adjustment taking place.

The $1,410 million estimated revenue cost for DISC year 1980 is based on the assumption that DISC income would be taxable to the parent at the statutory rate of 46% in the year in which earned. The estimate understates the revenue cost of DISC in those cases where the existence of a DISC enables taxation of the deemed distribution to be postponed until the next year. Such cases occur where the end of the DISC's fiscal year is one or two months later than the end of the parent corporation's fiscal year. The estimate, however, overstates the revenue costs of DISC to the degree that the marginal tax rate is less than 46%. As discussed in the previous chapter, the effect of net operating losses and excess tax credits is, in general, to reduce the tax saving to companies which export through a DISC. In those cases where net operating losses and excess tax credits cannot be carried forward, there is no tax saving from employing a DISC. Therefore, like the estimates of the export impact of DISC, the estimates of the revenue cost of DISC may be substantial overestimates. But whether or not they are overestimates, the relation between export impact and revenue cost is, as a first approximation, invariant with changes in the marginal tax rate since the impact and cost increase or decrease together in approximate proportion.

Table 4-1 presents the estimated revenue costs of DISC for calendar and fiscal years 1972 through 1979, as well as projected revenue costs for 1980 through 1987.[9] Adjusting DISC income in DISC year 1980 to a calendar year basis requires apportioning the income reported on all DISC returns filed for tax years which overlap calendar year 1979. This results in an estimate of DISC revenue cost for calendar year 1979 of $1,350 million. As

6. Other deemed distributions were interest derived from producer's loans made by a DISC, certain kinds of capital gains recognized by a DISC, and the amount of foreign investment attributable to producer's loans for the taxable year.
7. This base period applies to taxable years beginning in 1976 through 1979. Starting with taxable years beginning in 1980, the base period is advanced each year.
8. Additional deemed distributions which apply to accounting periods beginning after December 31, 1975, are 50% of taxable income attributable to sales of military property, income attributable to international boycott activity, and the amount of illegal bribes.
9. The $1,410 million estimate refers to DISC year 1980, and is therefore to be distinguished from the calendar and fiscal year estimates in Table 4-1.

Table 4-1

Revenue cost estimates and projections, actual tax rates and DISC provisions[1]
(Millions of dollars)

Year (1)	*Calendar year tax liability* Cost under original Act (2)	Cost reductions[2] Incremental provision (3)	Other (4)	TEFRA reduction (5)	Cost under present Law[3] (6)	*Fiscal year receipts foregone (present Law)*[4] (7)
	$	$	$	$	$	$
1972	350				350	100
1973	730				730	460
1974	1,120				1,120	850
1975	1,160		10		1,150	1,130
1976	1,160	370	40		750	1,020
1977	1,200	450	50		700	720
1978	1,430	440	50		940	830
1979	1,850	440	60		1,350	1,120
1980	2,170	530	70		1,570	1,450
1981	2,270	600	90		1,580	1,570
1982	2,090	630	100		1,360	1,550
1983	2,110	700	120	190	1,110	1,230
1984	2,180	800	130	190	1,060	1,080
1985	2,330	940	160	190	1,040	1,060
1986	2,500	1,050	190	190	1,070	1,060
1987	2,690	1,120	220	200	1,150	1,110

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1. The 1972 through 1979 figures are estimated from DISC returns. All other figures are projections. The projections for 1981 and subsequent years take into account the effect on DISC of the Accelerated Cost Recovery System (ACRS) introduced in the Economic Recovery Tax Act of 1981. The projections for 1983 and subsequent years take into account the effect of the Tax Equity and Fiscal Responsibility Act of 1982 on ACRS and the DISC deferral rates. All figures are based on the assumption that in the absence of DISC, the earnings would be subject to tax at the corporate tax rate which is 48% for 1972-78 and 46% for 1979 and subsequent years.
2. Net reduction in revenue costs as a result of changes provided for in the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Tax Equity and Fiscal Responsibility Act of 1982 (see Chapter 2 for details).
3. Column (2) minus the sum of columns (3), (4) and (5).
4. Calculated on the basis of normal relationships between calendar year corporate tax liabilities and fiscal year receipts. Fiscal years through 1976 end on June 30 of the corresponding calendar year, thereafter on September 30. The transition quarter in 1976 is not shown separately. The receipts estimate for that quarter is $110 million.

shown in column 3, the incremental provisions reduced the revenue cost of the original DISC program by 24% in calendar year 1979. Tax savings provided by the other amendments to the original DISC program (i.e. reduced benefits for military exports and the exclusion of certain natural resource products from DISC benefits) reduced the revenue cost of the original legislation by an additional 3.2% in calendar year 1979.

The projections for DISC year 1981 and subsequent years take into account the effect of ACRS on tax-deferred income. As indicated in the previous chapter, for companies employing the 50-50 pricing method, ACRS will reduce the tax benefit of DISC by reducing the effective, marginal corporate tax rate. For companies employing the 4% pricing method the revenue cost estimates of DISC wil not be affected by ACRS, since the tax benefit of DISC under this pricing method is not a function of taxable income but rather of gross sales, which are assumed to be unaffected by ACRS. However, under ACRS the ability of firms to use the 4% method may be increasingly limited by the requirement that income cannot be allocated to a DISC so as to leave the parent with a loss.

The projections for DISC year 1981 and beyond reflect projections of combined taxable income under ACRS, the current mix of pricing methods employed, and the appropriate deferral rate. For taxable years beginning after 1982, the deferral rate for corporate shareholders of a DISC falls from 50% to 42.5%. Because of data limitations the projections do not reflect the differences that may exist between the national mix of depreciable assets subject to ACRS and the mix of depreciable assets employed in the generation of exports sales through DISCs. The projections also do not reflect the degree to which companies may shift from the 50-50 method to the 4% method to put a floor on the reduction in the relative effectiveness of DISC brought about by ACRS or the degree to which the no-loss requirement may increasingly constrain the use of the 4% pricing method. Finally, the projections do not reflect the change in the marginal tax rate on DISC income that may be brought about by ACRS. On the one hand, ACRS will decrease the saving from tax-deferred income by increasing the amounts of net operating losses and excess tax credits through reductions in taxable income. The excess tax credits will be further increased by the enhanced investment tax credit provisions of ERTA. On the other hand the safe-harbor leasing provisions of ERTA will increase the tax saving from DISC tax-deferred income by decreasing the amounts of net operating losses and excess investment tax credits.

Distribution of DISC benefits

For corporate owners for which asset size is available, 65.9% of the tax-deferred income of the DISCs in DISC year 1980 accrued to the 7.3% of the DISCs with parent companies having assets of at least $500 million (see Table 4-2). The 179 DISCs with gross receipts of $100 million or more accounted for 60.2% of all tax-deferred DISC income (see Table 4-3). The 126 DISCs with net incomes of $10 million or more accounted for 59.2% of all tax-deferred income (see Table 4-4). Ten DISC parents accounted for 26.2% of all tax-deferred income and 27.5% of all net income.[10]

Data on the distribution of tax-deferred income DISCs owned directly or indirectly by foreign corporations are available only for DISC year 1975. They show that $85 million of DISC dividends – 4% of the total – were distributed to U.S. corporations with foreign owners; $2 million of DISC dividends – 0.1% of the total – were distributed directly to foreign corporations.

DISC elections

A cumulative total of 15,650 elections were made through February 1982 (see Table 4-5). This represents an increase of 1,854 or 13%, over February 1981. The data on DISC elections are not adjusted for DISCs that are inactive or that have been liquidated or have withdrawn their elections.[11] Nevertheless, the growth in election demonstrates the continued interest in the use of the DISC provisions.

CHAPTER 5
GENERAL STATISTICAL INFORMATION

This Report covers the eighth full year of DISC operations. The tabulations are based on a sample of 2,647 tax returns, Form 1120-DISC, filed by active DISCs for taxable periods ending between July 1, 1979, and June 30, 1980. This period is defined as DISC year 1980, although most of the activity it cov-

10. The fact that the distribution of tax-deferred income was less concentrated than the distribution of DISC net income reflects the exemption of small DISCs from the incremental provision of the 1976 Tax Reform Act.
11. For example, for accounting periods ending between July 1, 1979 and June 30, 1980, 7,933 DISC returns were filed even though 10,978 DISC elections had been made as of February 28, 1979. These two figures are chosen for comparison since a DISC election must be made, at the latest, within 90 days after the beginning of the DISC's taxable year, and the largest number of returns are for periods beginning in December 1978 and January 1979. The difference between these two figures reflects primarily the number of inactive DISCs, including newly created DISCs which have not yet begun operation. The number of DISC returns filed during DISC year 1980 increased by 725, or 10.1%, which is slightly faster than the growth in elections.

Table 4-2

Gross receipts, net income and tax-deferred income by asset size of corporate majority shareholder – DISC year 1980
(Dollar amounts in millions)

Asset size of corporate Majority shareholder	*Returns*		*Gross receipts*		*Net income*		*Tax-deferred income*	
	Number	*Percent of total*	*Amount*	*Percent of total*	*Amount*	*Percent of total*	*Amount*	*Percent of total*
All returns	7,933	100.0	131,976	100.0	8,426.5	100.0	3,065.9	100.0
No majority shareholder or assets not available	1,967	24.8	7,432	5.6	255.5	3.0	114.9	3.7
Returns with majority corporate shareholder	5,966	75.2	124,544	94.4	8,171.0	97.0	2,951.0	96.0
Returns with majority corporate shareholder								
Total	5,966	100.0	124,544	100.0	8,171.0	100.0	2,951.0	100.0
$1 under $100,000	77	1.3	91	0.1	5.8	0.1	2.8	0.1
$100,000 under $1,000,000	665	11.1	612	0.5	35.2	0.4	15.8	0.5
$1,000,000 under $5,000,000	1,811	30.4	3,285	2.6	188.9	2.3	85.2	2.9
$5,000,000 under $10,000,000	765	12.8	3,136	2.5	186.2	2.3	77.5	2.6
$10,000,000 under $50,000,000	1,406	23.6	12,090	9.7	773.9	9.5	305.9	10.4
$50,000,000 under $100,000,000	366	6.1	12,206	9.8	455.1	5.6	167.4	5.7
$100,000,000 under $250,000,000	262	4.4	4,983	4.0	416.2	5.1	149.1	5.1
$250,000,000 under $500,000,000	178	3.0	8,092	6.5	563.1	6.9	203.5	6.9
$500,000,000 under $1,000,000,000	175	2.9	20,112	16.1	939.6	11.5	343.1	11.6
$1,000,000,000 or more	261	4.4	59,937	48.1	4,607.0	56.4	1,601.0	54.3

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Table 4-3

Gross receipts, net income and tax-deferred income by size of gross receipts of the DISC – DISC year 1980
(Dollar amounts in millions)

Sizes of gross receipts	*Returns*		*Gross receipts*		*Net income*		*Tax-deferred income*	
	Number	*Percent of total*	*Amount*	*Percent of total*	*Amount*	*Percent of total*	*Amount*	*Percent of total*
All returns								
Total	7,933	100.0	131,976	100.0	8,426.5	100.0	3,065.9	100.0
Zero receipts	582	7.3	—	—	55.0	0.7	18.2	0.3
$1 under $50,000	317	4.0	6	*	–0.1	*	0.7	*
$50,000 under $250,000	909	11.5	129	0.1	16.4	0.2	8.2	0.3
$250,000 under $1,000,000	1,735	21.9	973	0.7	104.2	1.2	50.2	1.6
$1,000,000 under $10,000,000	3,193	40.2	10,641	8.1	823.8	9.8	335.0	10.9
$10,000,000 under $100,000,000	1,018	12.8	29,281	22.2	2,215.3	26.3	806.8	26.3
$100,000,000 under $250,000,000	109	1.4	17,500	13.3	1,194.8	14.2	420.1	13.7
$250,000 or more	70	0.9	73,446	55.7	4,017.1	47.7	1,426.7	46.5

Office of the Secretary of the Treasury; Office of Tax Analysis

* Less than 0.05%.

ers occurred in calendar year 1979.[12] Table 5-1 presents the total number of DISC returns filed for DISC years 1977-80, as well as statistics on DISC receipts, net income, and assets for each of these years.

DISC income

In DISC year 1980, net income attributable to DISC manufactured exports amounted to $7.7 billion. This figure is 160% greater than the amount reported in the second DISC year, 1974, and is 30% greater than net income reported in DISC year 1979. Because the 30% increase in net income slightly exceeded the 28% increase in DISC gross sales of manufactures, DISCs' average profit margin for all manufactured product classes rose from 8.1 to 8.2% of sales between DISC years 1979 and 1980. Table 5-2 presents statistics on DISC receipts, net income, and tax-deferred income by accounting period in DISC year 1980. The weighted average of tax-deferred income as a percentage of net income was 36.4%.

Table 5-3 presents data on the pricing methods used by DISCs. It shows that 34.8% of DISC sales were reported as being subject to the 50-50 pricing method, 34.1% to the 4% method, and 6.9% to the arm's-length pricing method. The remaining 24.2% of DISC sales were subject to some combination of these three methods or were shown on returns in which the pricing method could not be determined. This information can be used to estimate the combined profit margins of DISCs and their related suppliers. The average value of this combined margin for all manufactured exports sold through DISCs was 13.9% of gross sales in DISC year 1980.[13]

Balance sheet statistics

Table 5-4 presents year-end balance sheet statistics. Total assets of DISCs amounted to $24.1 billion, 22.3% higher than the previous year's figure. Of these assets, 61% consisted of trade receivables (accounts and notes receivable). The second largest asset item was producer's loans, which were 15% higher than in DISC year 1979. The category "other assets" increased by 52% between the DISC years 1979 and 1980, after increasing 42% the previous year. The fastest growing category was export property, which grew 76%.

On the liabilities and capital side in the lower part of Table 5-4, the largest item was accumulated DISC income, amounting to $20.0 billion, 83% of the value of liabilities and stockholders' equity. The amount of accumulated DISC income was approximately equal to the difference between total reported DISC earnings of $39.3 billion through DISC year 1980, and total reported actual DISC distributions of $17.5 billion.[14] Total actual DISC distributions through DISC year 1980 were $7.1 billion less than the amount deemed to have been distributed – and taxed – to shareholders. Retention of tax-paid earnings by DISCs presumably reflects the financial incentives involved, notably the favorable tax treatment of interest earned on qualified export receivables and other investments.

Income statement statistics[15]

Table 5-5 presents combined income statement statistics for all DISCs. While almost all of the qualified receipts of $43.6 billion consisted of receipts from the sale of export property, $1.2 billion constituted receipts from other sources. The largest item in this latter category was interest income amounting to almost $730 million.

12. Because the majority of DISCs have tax years ending in December 1979 or January 1980, roughly 83% of the exports reported in DISC year 1980 occurred in calendar year 1979. Consequently, activities in 1979 are major determinants of the results reported for DISC year 1980. DISC year 1980 is equivalent to statistical year 1979 as used by the Internal Revenue Service. See Appendix A for definitions and a description of the sampling procedure (not reproduced here).

13. Statistics for DISC exports of non-manufactured products, specifically agricultural products, are overstated relative to actual exports because of inter-DISC sales. Thus, the ratio between DISC net income and gross receipts for agricultural products does not represent the true rate of return on DISC exports of these products. For an explanation of the derivation of the combined profit margins, see pages 35-36 of the 1976 Report.

14. The difference between accumulated DISC income and total earnings less actual distributions is due to statistical and reporting errors.

15. Note that, for income statement purposes, receipts include only the commissions in the case of goods sold on a commission basis.

As would be expected, the largest deduction was the $32.9 billion for cost of goods sold and cost of operations. The only other significant deduction was for export promotion expenses, amounting to just over $1.2 billion or 1% of the value of total DISC exports.

Audit results

Substantial adjustments in DISC income were proposed in calendar year 1981 as a result of audit examinations. In total, DISC income was reduced by $617.3 million and the income of parents was increased by the same amount. Tax liabilities increased by about $55 million. Most of the proposed adjustments were for the years from 1976 to 1979. More than 74% of the reduction of DISC income was due to intercompany pricing adjustments. Apparently these were largely the result of the failure of parents and their DISCs to have explicit written agreements on their exact pricing rules. The only other significant reason for proposed adjustments to DISC income was the disallowance of DISC status because the corporation did not meet the 95% export assets test in section 993 of the Internal Revenue Code.

Table 4-4

Gross receipts, net income and tax-deferred income by size of net income of the DISC – DISC year 1980

(Dollar amounts in millions)

	Returns		*Gross receipts*		*Net income*		*Tax-deferred income*	
Sizes of net income	*Number*	*Percent of total*	*Amount*	*Percent of total*	*Amount*	*Percent of total*	*Amount*	*Percent of total*
All returns	7,933	100.0	131,976	100.0	8,426.5	100.0	3,065.9	36.4
Less: Deficit returns	703	8.9	3,388	2.6	–36.8	–0.4	——	——
Returns with zero net income	106	1.3	313	0.2	——	——	——	——
Returns with net income	7,124	89.8	128,275	97.2	8,463.3	100.4	3,065.9	36.4
$1 under $100,000	3,486	43.9	3,919	3.0	133.3	1.6	63.3	47.5
$100,000 under $200,000	1,042	13.1	3,011	2.3	151.0	1.8	66.8	44.2
$200,000 under $1,000,000	1,672	21.1	13,385	10.1	739.3	8.8	289.3	39.1
$1,000,000 under $5,000,000	678	8.5	22,229	1.7	1,468.1	17.4	538.5	36.7
$5,000,000 under $10,000,000	120	1.5	11,149	8.7	821.4	9.7	291.9	35.5
$10,000,000 under $25,000,000	81	1.0	16,893	12.8	1,231.4	14.6	439.8	35.7
$25,000,000 under $50,000,000	24	0.3	7,953	6.0	829.8	9.8	289.8	34.9
$50,000,000 or more	21	0.3	49,465	37.5	3,089.0	36.7	1,086.5	35.2

Office of the Secretary of the Treasury; Office of Tax Analysis

Table 4-5

DISC elections

End of period		*Cumulative total*
1972 –	March	1,136
	June	2,412
	September	3,049
	December	3,439
1973 –	March	3,842
	June	4,164
	September	4,446
	December	4,825
1974 –	March	5,184
	June	5,570
	September	6,569
	December	6,738
1975 –	March	7,293
	June	7,653
	September	7,956
	December	8,258
1976 –	March	8,522
	June	8,805
	September	9,070
	December	9,331
1977 –	February	9,447
	June	9,718
	September	9,827
	December	10,024
1978 –	February	10,144
	June	10,341
	September	10,552
	December	10,780
1979 –	February	10,978
	June	11,285
	September	11,667
	December	11,924
1980 –	February	12,192
	June	12,645
	September	13,061
	December	13,489
1981 –	February	13,796
	June	14,425
	September	14,906
	December	15,355
1982 –	February	15,650

Office of the Secretary of the Treasury; Office of Tax Analysis

In next issues:

Tax ratio and tax effort analysis: A critical evaluation
– by *M.M. Ansari*

Sales tax controversy in India: An evaluation
– by *G. Thimmaiah*

Sales taxes in OECD Member Countries
– by *S. Cnossen*

Attempts to curb treaty shopping in U.S.–Dutch treaty negotiations
– by *R.D. Kramer*

The relationship between internal law and tax treaty law
– by *M.J. Ellis*

Table 5-1

Historical statistics, DISC years 1977-1980
(Dollar amounts in millions)

	1977	*1978*	*1979*	*1980*
Number of returns, total	6,911	6,665	7,208	7,933
Full year	6,421	6,316	6,768	7,354
Part year	490	349	440	579
Gross receipts, total	82,681	85,887	99,603	131,976
Non-manufactured products	23,997[1]	25,521[1]	26,038[1]	37,867
Manufactured products	58,684	60,366	73,566	94,109
Export receipts, total	82,681	85,887	99,604	131,976
Canada	11,382	n.a.	14,360	n.a.
Latin American republics	8,334	n.a.	11,691	n.a.
Europe	26,261	n.a.	30,395	n.a.
Japan	7,287	n.a.	8,927	n.a.
U.S. destinations	4,691	n.a.	4,701	n.a.
All other and unallocated	24,726	n.a.	29,530	n.a.
Net income	5,602	5,211	6,402	8,427
Non-manufactured products	421	411	480	728
Manufactured products	4,651	4,800	5,923	7,699
Tax-deferred income	1,572	1,519	2,071	3,066
Non-manufactured products	145	139	171	284
Manufactured products	1,427	1,380	1,901	2,782
Total assets, end of year	14,678	15,955	19,725	24,161
Trade receivables	8,840	10,162	12,416	14,897
Other assets	5,838	5,793	7,309	9,264
Accumulated income, end of year	8,527	9,560	11,383	14,146

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1. Statistics on DISC sales of non-manufactured products, specifically agricultural products, exceed U.S. exports from all sources by a substantial margin because of inter-DISC sales. Therefore, gross receipts of non-manufactured products overstate exports of these products.

n.a. = not available.

Table 5-2

Gross receipts, net income and tax-deferred income by accounting period – DISC year 1980
(Dollar amounts in millions)

Accounting period ending	*Number of returns*	*Gross receipts*	*Net income*	*Tax-deferred income*	*Tax-deferred income as a % of net income*
All returns	7,933	131,976	8,426.5	3,065.9	36.4
Full year returns, all periods	7,354	129,297	8,353.9	3,025.7	36.2
July 1979	446	3,412	229.1	87.0	38.0
August 1979	317	1,442	90.3	33.2	36.8
September 1979	534	4,156	190.9	71.0	37.2
October 1979	419	5,947	449.8	161.3	35.9
November 1979	343	2,480	201.2	73.8	36.7
December 1979	1,627	35,839	2,538.7	901.0	35.5
January 1980	1,347	33,460	3,111.6	1,117.4	35.9
February 1980	325	6,128	365.5	128.6	35.1
March 1980	549	6,436	303.8	114.0	37.6
April 1980	432	4,162	266.0	100.8	37.6
May 1980	347	13,964	295.5	118.2	39.9
June 1980	668	11,871	311.5	119.5	38.4
Part year returns, all periods	579	2,679	72.6	40.2	55.4

Office of the Secretary of the Treasury; Office of Tax Analysis

Table 5-3

Gross receipts, net income and tax-deferred income by pricing method – DISC year 1980

(Dollar amounts in millions)

Pricing method	*Number of returns*	*Gross receipts*	*Net income: Amount*	*Net income: Percent of gross receipts*	*Tax-deferred income*
			All products		
All returns	7,933	131,976	8,426.5	6.4	3,065.9
Returns reporting pricing method	6,467	125,499	8,143.8	6.5	2,949.6
50-50 method	3,246	45,904	4,787.7	10.4	1,765.9
4% method	1,727	45,045	1,096.3	2.4	399.2
Arm's-length method	1,041	9,119	478.6	5.2	182.5
50-50 and 4%	429	23,635	1,711.9	7.2	575.3
All other combinations	24	1,796	69.3	3.8	26.9
Pricing method not determinable	1,466	6,476	282.7	4.4	116.3
			Non-manufactured products		
All returns	953	37,867	728.1	1.9	284.4
Returns reporting pricing method	525	35,314	684.6	1.9	263.6
50-50 method	172	1,292	114.5	8.8	44.3
4% method	189	27,660	465.8	1.7	174.2
Arm's length method	135	3,703	24.3	0.6	13.4
All combinations	29	2,660	80.1	3.0	31.8
Pricing method not determinable	428	2,553	43.5	1.7	20.8
			Manufactured products		
All returns	6,980	94,109	7,698.4	8.2	2,781.5
Returns reporting pricing method	5,942	90,185	7,459.2	8.3	2,686.1
50-50 method	3,074	44,613	4,673.2	10.5	2,686.1
4% method	906	17,385	630.5	3.6	1,721.6
Arm's-length method	424	5,416	454.3	8.4	224.9
All combinations	1,036	22,771	1,701.1	7.5	570.3
Pricing method not determinable	1,038	3,924	245.4	6.2	95.5

Office of the Secretary of the Treasury; Office of Tax Analysis

Table 5-4

Balance sheet statistics – DISC year 1980
(Millions of dollars)

	All products
Total assets	24,161
Qualified assets, total	24,105
Working capital	475
Export-Import Bank obligations	1,211
Trade receivables	14,897
Export property	1,588
Producer's loans	3,484
Other	2,450
Non-qualified assets	56
Total liabilities and capital	24,161
Liabilities, total	3,902
Accounts payable	2,340
Other current liabilities	969
Mortgages, notes, bonds payable in one year or more	213
Other liabilities	380
Capital accounts, total	20,259
Capital stock and paid-in surplus	253
Previously taxes income	5,860
Tax-deferred income	14,146

Office of the Secretary of the Treasury; Office of Tax Analysis

Table 5-5

Income statement statistics – DISC year 1980
(Millions of dollars)

	Number of returns	*Amount (millions)*
Total receipts[1]	7,538	43,575
Qualified export receipts, total	7,498	43,408
Qualified receipts from property sales	7,175	42,180
Other qualified receipts, total	3,881	1,228
Leasing of export property	69	49
Services related to qualified exports	286	63
Engineering and architectural services	101	100
Qualified dividends	37	27
Interest on producer's loans	1,684	245
Other interest	2,324	730
Other qualified receipts	n.a.	14
Non-qualified receipts, total[2]	1,077	193
Total deductions	6,688	35,175
Cost of sales and operations	3,628	32,920
Export promotion expenses	3,613	1,238
Other expenses	5,986	1,017
Total receipts less total deductions	7,119	8,400
Net income	7,827	8,426
Tax deferred and taxable income	7,102	8,461
Total deemed distributions	7,013	5,397
Attributable to base period export gross receipts	2,485	1,934
All other deemed distributions	n.a.	3,463
Actual distributions	1,414	4,144

Office of the Secretary of the Treasury; Office of Tax Analysis

1. For income statement purposes receipts include only the commission earned on commission sales.
2. Net of adjustments to income.

n.a. = not available.

AUSTRALIAN TAXATION RESEARCH FOUNDATION

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Initially, research will be undertaken on a contract basis by researchers who are recognised as pre-eminent in their particular fields. They will be drawn from academic, business and professional sources.

Later the Foundation hopes to arrange conferences on major aspects of taxation research and to publish occasional papers on various taxation questions.

It will also issue regular information bulletins to inform the public of its work in areas covering not only corporate taxes but affecting the individual taxpayer.

A Board of Governors, appointed by the sponsoring bodies, will direct the operations of the Foundation. It will have complete freedom of action and will, in no sense, comprise a board speaking only for the sectional interests of the sponsoring bodies.

Membership will not be confined to the professions involved and will be open to corporations, unions, community groups and individuals with an interest in taxation matters.

The enormity of the task facing the Foundation is not underestimated by the sponsoring bodies.

The existing taxation system is complicated and includes a mishmash of provisions superimposed from time to time on an already complex framework.

A system which permits various groups in the community to arrange their affairs to permit significant reductions in the incidence of taxation while precluding others from doing so, serves to foster resentment among taxpayers, often fuelling a temptation to seek to avoid taxation by questionable means.

The Foundation recognises that fundamental differences exist in political philosophy and social objectives, making it impossible to formulate a taxation system which is universally acceptable.

By adopting a scientific, realistic and objective approach to the issues involved, the Foundation hopes to contribute significantly towards the development of a system which recognises basic fundamentals, which is fair and equitable, and which will be acceptable to most of the community, most of the time.

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United Kingdom:

"Freeports in Britain"

Memorandum prepared by the Institute of Directors for the Committee on Scottish Affairs[1]

1. The Institute submits this memorandum in response to an invitation from the Committee on Scottish Affairs.

2. The Committee is concerned with the specific proposal that "Prestwick Airport might become a freeport, providing similar facilities to those available (for example) at Shannon and Hamburg".

3. The Institute considers, however, that before considering the merits or otherwise of establishing a freeport at Prestwick Airport it is appropriate to review in more general terms theory, practice and literature relating to the freeport concept. It considers that the potential economic significance of freeports in Britain is such that any decision on the establishment of one or more freeports should follow careful policy consideration at national level. Only thereafter should particular sites be examined.

FREEPORTS ELSEWHERE IN THE WORLD

4. Free trade zones are to be found in Europe, Asia and the United States. There are now about 400 freeports in 76 countries in every continent except Australia.[2]

5. Asian free trade zones – also called free export zones or export processing zones – are perhaps the most widely known freeports and those purest in their concept. They include Hong Kong, South Korea, Taiwan and Singapore but in the past decade the concept has spread to less developed economies in China, South Asia and Indonesia.

6. Far Eastern free trade zones tend to offer the maximum package of benefits likely to be found by foreign investors:
No customs duties
No import quotas
No foreign exchange controls
Unlimited profits repatriation
Long tax holidays
Preferential credit
Subsidised utilities
No local or provincial taxes
Anti-strike laws
100% foreign ownership permitted.

7. Countries like Hong Kong and Singapore have, in the words of one commentator[3], relied entirely on the freeport strategy to achieve enviable economic growth rates. Some of the second wave of states now attempting to establish freeports, which are less-developed, seek to attract from intermediate countries the most labour-intensive, low skill investments such as food processing, garments and electronics assembly.

8. It is apparent that the package of benefits which are relevant to these aspirations will not necessarily correspond with British needs. The Max Planck Institute has commented that "what appears in the statistics as manufacturing of a highly sophisticated technical product consists in reality in the performance of a few routine operations, mainly soldering and assembling under a microscope by semi-skilled cheap labour".[4]

9. Yet the growth and economic performance rates of established freeports like Hong Kong and Singapore means that Britain cannot afford to ignore the significance of this factor in attracting foreign investors for particular processing operations. With a population of some 50 million in a world market of 4,000 million, Britain too must examine every means of improving its attractiveness to investors operating on a world scale.

UNITED STATES OF AMERICA

10. A freeport system more suited to a developed economy may be that operated in the United States. In the U.S.A. some 74 "foreign trade zones" have been approved with 18 applications pending under the Foreign Trade Zones Act of 1934.[5]

11. U.S. Government literature states that "Zones are operated as public utilities by states, political subdivisions or corporations chartered for the purpose. Subzones are special purpose facilities for companies unable to operate effectively at public zone sites.

12. "Foreign trade zones usually are located in or near customs ports of entry at industrial parks or terminal warehouse facilities. Sub-zones are located at the zone user's private facility."[6]

13. The advantages of using foreign trade zones listed by the U.S. Customs Service include:
(a) Customs duty and internal revenue tax, if applicable, are paid when merchandise is transferred from a foreign trade zone to the customs territory for consumption.
(b) While in a zone, merchandise is not covered by a customs bond or subject to U.S. duty or excise tax.
(c) Goods may be exported from a zone free of duty and tax.
(d) Customs procedural requirements are minimal.
(e) Customs security requirements provide protection against theft.
(f) Merchandise may remain in a zone indefinitely, whether or not subject to duty.
(g) The zone user who plans to enter merchandise for consumption in customs territory may elect to pay either the duty and taxes on the foreign material placed

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1. July 1982.
2. Source: *Export Direction*, June 1982.
3. Far Eastern Economic Review, 18 May 1979.
4. Id.
5. *Export Direction*, June, 1982.
6. Department of the Treasury, U.S. Customs Service, Washington, 1979 C: 79-2.

in the zone or on the article transferred from the zone. The rate of duty and tax and the value of merchandise may change as a result of manipulation or manufacture in the zone. Therefore, the importer may pay the lowest duty possible on the imported merchandise.

(h) Merchandise under bond may be transferred to a foreign trade zone from the customs territory for the purpose of satisfying a legal requirement to export or destroy the merchandise.

14. Examining the growth and factors influencing the success of the U.S. zones, Mr. John H. Leeper[7] has pointed out that "of the 45 authorised U.S. foreign trade zones that exist today only 7 were approved prior to 1970. Clearly, the rush in foreign trade zones has occurred in the decade of the 1970s."

15. Mr.Leeper comments:

"The object of establishing a foreign trade zone is to attract economic activity consistent with national policy. Ideally, this activity should not replace existing domestic employment but rather repatriate overseas operations of U.S. multinationals, attract foreign investment to the United States, or encourage domestic firms to expand their international trade activity.

"Typical foreign trade zone tenant activities range from storage, re-export; inspect and re-export; assembly, storage and assembly; storage and re-export; manufacture.

"Tenants of U.S. foreign trade zones currently include many of the largest U.S. and international manufacturing and distributing corporations. Among these are Lear Jet; Control Data Corporation; Rockwell International; Hughes Aircraft; IBM; Samsonite; Motorola; General Goods Corporation; Bristol Laboratories; Sears, Roebuck; Heublein; Almaden Vineyards; McCormick Distillers; Colorox Company; Ford Motor Company; General Mills; H.J. Heinz Company; Pillsbury; Mobil Oil; Evinrude Motors; Sony; RCA; and Uniroyal International."[8]

16. What are typical advantages of foreign trade zone operation seen by U.S. companies? Leeper identified five particular cases:

(a) High volumes of imports are held as inventory and then distributed in the United States. By storing and distributing goods from a zone, the customs duties can be delayed and the interest charges on borrowed working capital can be eliminated. For instance, merchandise ordered for Christmas sale can be stored in and distributed from a zone.

(b) Higher customs duties are levied on parts than on the finished products. If a product is already being assembled in the United States from a variety of internationally produced components, the cost of production can often be lowered by the difference in customs duties. For instance, there are no duties on imported agricultural tractors, but there are duties on tractor parts. Assembly in the United States from foreign components is therefore more advantageous in a zone.

(c) Supplies are being provided to foreign-bound ships and airplanes. If products imported into the United States are then sold to foreign-bound ships and airplanes, the customs duties can be eliminated altogether by distributing them from a zone. For instance, liquor for cruise ships is often distributed from a zone.

(d) Indefinite storage of high value imported products is required. If an importer needs extraordinary security, the zone can provide protected space at a reasonable cost and often at reduced insurance costs. For instance, a sophisticated machine may have been ordered for a construction project long before it was needed because of the favourable price. Until it is needed, it can be stored in the zone without concern about pilferage.

(e) Goods that require inspection and quality control and resultant shipment command a lower duty. For instance, an importer may bring in large quantities of untested electronic components. By testing them in a zone, the importer then accepts only the usable components and does not pay duties on the entire batch.

17. Of particular interest is the U.S. concept of sub-zones for manufacturing operation. The Volkswagen assembly plant at New Stanton, Pennsylvania is a sub-zone of Foreign Trade Zone 33. By 1980 it produced 1,000 units per day for the U.S. market, employing some 4,500 people. A further manufacturing sub-zone contains an Olivetti manufacturing plant.

18. *United States experience suggests that the freeport concept has a valuable role to play in developed economies and is compatible with standard customs procedures.*

19. And the lessons of the United States foreign trade zones are relevant to British consideration of the concept. First, as Leeper suggests, foreign trade zones cannot be successful simply because of their supposed inherent advantages:

"The difficulty arises when the grantee – usually a quasi-government corporation or agency – fails to realise that it is in a highly competitive market in which the buyers (potential tenants) are sophisticated, profit-orientated businessmen. The grantee-operator has to provide a service and environment that are competitive with other foreign trade zones, both in the United States and abroad, and must have the tenants' current and long-term profitability firmly in mind."

20. Secondly, zones will not necessarily succeed, and certainly will not succeed alone, in regenerating areas of declining economic activity. They may, on the contrary, tend to be most successful in and to lure businesses towards areas which are already attractive for company location.

"Some foreign trade zones such as the New York zone attract tenants naturally. With its large international trading community and major air and marine terminals, the New York zone has only to provide reasonably efficient management to ensure a high rate of use. For other zones, the task can be more difficult; major educational and incentives programs must often be initiated to attract tenants."

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7. Transportation Research Record 763, U.S. Committee on State Role in Waterborne Transportation.

8. Id.

21. The thrust which led to the establishment of U.S. foreign trade zones came, according to U.S. Government literature, from "the success of free trade zones in Northern Europe, notably the 'free port' of Hamburg."

22. Yet it is frequently argued that current EEC legislation would make it difficult for Britain to introduce a freeport regime without infringing EEC law. Existing customs reliefs and deferral arrangements for duty, it is argued, go as far as is possible towards meeting the freeport concept. The Institute of Directors is not satisfied by these arguments.

23. With the co-operation of the Royal Netherlands Embassy the Institute has examined existing arrangements currently in force in the Netherlands, another EEC member state. They demonstrate clearly that it would be within the bounds of EEC law and practice to establish in Britain freeports containing many of the features of U.S. foreign trade zones, but falling short of fully-fledged manufacturing operations.

24. EEC Directive 75 of 1969 harmonises community law relating to "free zones", defined in Art. 1 as "any territorial enclave established by the competent authorities of Member States in order that goods therein may be considered as being outside the customs territory of the Community for the purposes of applying customs duties, agricultural levies, quantitative restrictions or any charges or measures having equivalent effect".

25. The effects of the Directive are seen in three ways. First, it seeks to prevent different tax and duty regimes within freeports from distorting trade flows within the Community's customs union; secondly, it seeks to equate the duty treatment of freeport goods with the inward processing reliefs available to enterprises situated outside freeports; third, through EEC regulation 71/235, it regulates the nature of activities extending beyond pure storage which may be carried on within a freeport. The regulation in effect confines activity to certain forms of processing falling short of manufacturing operations; and integrates permissable activities with those applicable to bonded warehouses of different types within the Community.

26. Yet it is the Institute's opinion that the combined effect of EEC Directives and regulations does not prohibit the establishment in Britain of what are in effect freeports containing most of the features by which such entities are generally recognised.

27. *The way in which the Netherlands government operates an extended bonded warehouse system which in effect amounts to a freeport arrangement is clearly demonstrated in its export promotional literature.*

28. The following extract from "Trading in the Netherlands", an information booklet in English produced by the Ministry of Economic Affairs, makes it clear that the bonded warehouse system in the Netherlands is operated in a manner which encourages both the greatest flexibility of movement of goods and the maximum use of deferral of tax and duty:

"The Netherlands does not have freeports or free zones in the real sense of the word, but operates a very flexible and efficient system of customs sheds and bonded warehouses throughout the country to meet the needs of trade and industry. These give ample opportunities for the establishment of international distribution centres.

"The advantage of the Dutch system is that an enterprise is not bound to a specific site but can be located anywhere in the country, either at harbours or airports or inland. The Netherlands provides a great number of inland customs depots, although the largest concentration and best facilities are found at the seaports and airports.

"The system thus provides an extensive network of bonded storage combined with administrative control without the geographical restrictions of a freeport.

"Many bonded warehouses and customs sheds are privately owned and operate on a strict commercial basis for third parties. The foreign principal retains legal ownership of the goods stored. The service of the warehouse company is not limited to storage, packing, distribution and transport, but includes administrative handling, such as bills of lading, insurance, claims, financing, superintending, origin certificates, invoices, etc. The services rendered by bonded warehouses are often dealt with by computerised billing systems. Goods stored in bond are not liable for any import duties, agricultural levies, VAT or excise duties. Payments for these is due at the moment of declaration and clearance for consumption within the Netherlands, although a month's credit is normally allowed. It is also possible to release goods by paying only the import duty and bringing them to 'free circulation' in the EEC if destined for delivery to another member state."[9]

29. The same document makes it clear that a wide range of "customary handling" activities may be carried on within the extended bonded warehouse system:

"Goods stored in bond may undergo customary handling, such as repacking, marking, examining, cleaning, repairing, blending, mixing, bottling, etc. Industrial processing is not, under EEC rules, permitted in bond, but there are sufficient possibilities for further processing of goods as mentioned above.

"Transportation between ports, inland customs depots, warehouses, and factories is duty-free provided certain conditions and administrative formalities are fulfilled. Private companies may be engaged to handle transportation, storage and customs clearance.

"Bonded goods to be transported through the large seaports like Rotterdam and Amsterdam may be carried on open lorries without any customs seal or customs supervision. *This so-called 'flag conveyance' gives a complete 'freeport effect' throughout the whole port area. It is one of the main aspects of the liberal customs system at Dutch harbours and airports.* (Emphasis added.)

"Goods stored in bond never lose their origin and/or possible preference rights during storage, apart from time limits in the case of tariff quotas."

30. In addition to these general advantages, Dutch government literature is careful to emphasise that there are no fewer than 6 different types of bonded warehouse arrangement to satisfy particular needs:

(a) preliminary storage in customs sheds or approved depots

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9. Trading in the Netherlands, Ministry of Economic Affairs.

(b) temporary storage in customs depots or warehouses
(c) permanent storage in public bonded warehouses
(d) private bonded warehouses
(e) merchant-controlled bonded warehouses without physical customs control
(f) merchant-controlled bonded warehouses with administrative control.

31. Different procedures and requirements apply to each class of warehouse and it is not the Institute's purpose in this memorandum to consider these in detail. It is, however, highly relevant to British examination of the freeport concept that the Dutch system is designed towards the maximum freedom of movement of goods, the reduction of customs bureaucracy and the promotion of free trade. The Institute understands that the National Economic Development Council is considering the broad question of measures which might be taken in Britain to maximise in similar manner the attraction of Britain as a freight distribution centre within the Community.

32. One particular variant of the Dutch bonded warehouse system, however, so closely corresponds to the freeport concept that it is often described as a "mini freeport" in Dutch Government and Chamber of Commerce literature.

33. Variant (e) above, the public bonded warehouse, is an enclosed area and its operation in Rotterdam is described as follows by the Rotterdam Chamber of Commerce:
"It has only one gate, blocked by a boundary post and strictly watched by customs officials, who control all the out-going traffic. *The enclosure, its building, sheds, cranes, harbour etc. are owned, rented and partly run by the municipality; the whole could be considered as a 'piece of foreign country' within Rotterdam or even as a 'little freeport', without the facilities of processing or manufacturing goods.*"[10]

34. Dutch Ministry oi Economic Affairs literature states:
"Public bonded warehouses are under strict customs supervision and are intended for use as storage depots during long-term periods and for those operations such as repacking for which another type of bonded storage is not preferable.
"Public bonded warehouses are generally supervised by municipal authorities, but are run by private enterprise. Stock need not be checked during storage but careful checks are made when they enter or leave the warehouse. Customs authorities do not require a financial guarantee. Unlike other bonded warehouses, this type of warehouse can be established only in a limited number of places: Amsterdam, Delfzijl, Dordrecht, the Rotterdam port area, Schiphol airport, and Flushing. The period of storage is unlimited. Negotiable warrants can be issued. No duties or taxes are due for goods lost during storage. Exit and entry are possible only through one customs gate which functions as a foreign border, so that *Dutch public bonded warehouses may well be compared with free zones in other countries.*"
"In Rotterdam a so-called system of 'flag conveyance' exists, an 'open' conveyance, without customs seals, in order to allow an unimpeded transport of customs goods within the Rotterdam Port Area.
"During transportation the open lorry must carry an indicative sign of the type prescribed.
"Flag-conveyance is permitted within the whole area of the New Waterway, from quay to waterhouse, from dock to dock, from warehouse to ship or shed etc. The borders of the Port Area have been generously fixed, as all harbour-territory, quays, railway stations and the airport are part of the area in which flag-conveyance is permitted.
"(The flag-conveyance system) not only enables customs goods to be moved practically unhampered through the whole Port Area, but also *underlines Rotterdam's character as a very extensive freeport.*" (Emphasis added.)

CONCLUSION

35. The conclusion the Institute's preliminary investigations have led to is this. Freeports are developing rapidly in the Far East and in the United States. This presents a significant competitive challenge to Britain in circumstances where a fast pace of change in international investment, manufacturing and distribution operations means that every marginal incentive which might induce large investment flows and attraction of trade to Britain must be explored in detail. EEC Directives and Regulations do impose some restrictions on the operation of freeports in member states, primarily by limiting the forms of handling which may be carried on. But our examination of Dutch practice, in collaboration with the Royal Netherlands Embassy, shows not only that a liberal interpretation of these requirements is possible but also that bonded warehouse and customs relief systems constituting what are in essence freeports can exist under community law. The Dutch system of public bonded warehouses in several ports, and the flag-conveyance system operated in Rotterdam and elsewhere, suggest the way in which a British freeport system could be established.

36. Existing arrangements for inward processing relief, by which goods imported from outside the EEC for processing prior to exportation to a destination outside the Community, are not, in the Institute's opinion, incompatible with a wider freeport system in Britain. Nor do existing arrangements provide the demonstrable benefits of zones surrounding air or sea ports in which a series of advantages to importers, exporters, processors and freight forwarders are concentrated. It is this concept which reduces administrative cost and complication and maximises the marketing opportunities for Britain to compete with her rivals as a gateway for European and world trade, which the Institute considers it vital to develop.

37. The Institute would be concerned if the government failed to examine these possibilities in detail. In its view the time has arrived to commission a full feasibility study by professional external consultants, in co-operation with NEDC's work on freight forwarding, and with the

10. Bonded storage in Rotterdam, Chamber of Commerce of Rotterdam and the Lower Maas, 1971; also correspondence Royal Netherlands Embassy to Institute of Directors 1982.

Institute of Freight Forwarders together with interested local authorities and air and seaport operators. The Institute will be happy to play its part in such a study.

38. Ministers should take an early decision as to the proper scope of such a study. The Institute of Directors believes that it should concentrate upon the potential for an integrated freeport and bonded warehouse system around designated air and sea ports with deferral of duty and value added tax on goods within the zone; in short, a system which basically follows Dutch practice, but also corresponds with the U.S. foreign trade zones system, with the significant exception of manufacturing of goods.

39. The Institute does not believe that a wider range of concessions – for example, corporation tax holidays or local authority rate exemptions – would be compatible with EEC freeport legislation. Nor does it consider them likely in the long-term to be a legitimate part of trade incentives. General rate and tax concessions made available in enterprise zones have generated strong protests from businesses situated just outside the zones, and the Institute has considerable sympathy with these complaints. Whilst such concessions may be justifiable as last-ditch means to regenerate areas of major economic decline successful freeports are likely to be found in areas where the local economy is already strong.

40. Prestwick Airport may well prove to be suitable for freeport arrangements of the type prescribed. Much will depend upon the effectiveness of the local authority and its partners in such an enterprise in marketing the concept nationally and internationally. For the reasons stated in paragraphs 3 and 20 above, however, the Institute is not able at this point to comment in detail upon the potential of Prestwick as a site. A broader feasibility study, and establishment of national policy by the Department of Trade and HM Customs and Excise, must come first.

Working Party on Freeports

In a written Parliamentary answer dated 8 December 1982 the Economic Secretary to the Treasury, Mr. Jock Bruce-Gardyne, announced the setting up of an interdepartmental working party to examine the facilities available in freeports and zones in the European Community and elsewhere, with a view to identifying whether they could with benefit be introduced in the United Kingdom. He invited comments from interested parties. The Economic Secretary stated:

> An inter-departmental working party has been set up under my chairmanship with the following terms of reference:
> 1. To identify and evaluate the benefits to industry and commerce of the customs facilities afforded at freeports situated both in the community and elsewhere and to identify which of these facilities would encourage industrial growth and investment in the U.K.
> 2. To consider the extent to which customs facilities currently available in the United Kingdom compare with those permitted in freeports under EC legislation.
> 3. To consider whether there is sufficient awareness on the part of both U.K. commerce and industry and of potential investors from overseas of the advantages offered by existing customs facilities.
> 4. To make recommendations.
>
> The intention is to produce a report early in the New Year. The working group will wish to take full account of commercial interests and I accordingly invite interested parties to write to me expressing their views.

Note

A freepost or freezone is an enclave treated as being outside the customs territory of the host state, and inside which goods can be manufactured, processed and stored without payment of customs duties and subsequently exported. Customs duties and internal taxes are payable only if the goods pass from the zone into the home market. The freeports question has of late attracted a good deal of interest in both Parliament and in the Press. Advocates of such a system argue that freeports attract and stimulate export trade and capital investment from overseas, and thus increase employment and prosperity by the introduction of new work. The Government has decided that a detailed study should be undertaken to examine whether the establishment of freeport facilities would be beneficial to industry and commerce in the United Kingdom.

Comments from interested parties should be addressed to the Economic Secretary to the Treasury, H. M. Treasury, Great George Street, London SW1, or to H. M. Customs and Excise, Room 21/6, Kent House, Upper Ground, London SE1.

ISLE OF MAN:

Duty-Free Zones

Report prepared by the Collector (Customs & Excise)[1]

The idea of a Duty-Free Zone is immediately appealing and the possibility of establishing such a zone has arisen in recent times in many parts of the U.K. This has often been seen as a method of resurrecting the economy of a depressed area although of the six places in the U.K. for which such a zone has been recommended in the recent report to the Department of Trade by the Adam Smith Institute the choice of Aberdeen, the busy centre of the North Sea Oil industry, can hardly fall within that category.

The earliest freeports were in the ancient entrepot ports of the Middle East and the Mediterranean for the purpose of providing customs-free facilities for land locked neighbouring states. A freeport or free zone today is usually an enclosed area next to an international port or airport where imported goods may be landed, stored and operated upon without payment of customs and other duties. It is generally considered to be outside the territory of the state and to be an area where traders can carry out their business without bureaucratic constraints.

Relatively undeveloped countries which have a plentiful supply of cheap labour are often prepared to offer a wide range of financial benefits to attract export based industries. The more developed nations tend to adopt a much stricter attitude. Their industries tend to be well established and would be undermined by the competitive margin which the zones would provide if allowed to operate without restriction.

Within the European Community the philosophy is that such zones should be conducted under the same general conditions that apply at large in order to prevent distortion of trade. Directives on Duty-Free Zones, warehousing and inward processing set out detailed provisions which ensure that the facilities granted are no greater than those generally available.

Since joining the Community the trade of Britain with other member states has increased considerably. This has resulted in a large proportion of both raw materials and manufactured goods being in free circulation. Combined with the world-wide reduction in customs tariffs this has resulted in some 80% of U.K. industrial imports being free of duty or at a very low rate.

The duty-free side of the zone can thus be seen to be less attractive than would be the case with a high tariff barrier and other incentives are needed to induce traders to set up business in the zones. This can take the form of tax relief, investment grants, and reduced rents and rates which the U.K. government has used in its 1980 Enterprise Zone package. It should be pointed out that the U.K. Enterprise Zones are not claimed to be Duty-Free Zones but customs warehousing and inward processing can be carried out there as they can anywhere in the U.K. It is perhaps significant to note that no new Duty-Free Zone has been established in the Community since its inception.

Nevertheless there are succesful duty-free zones within the Community. *Hamburg* has a long history as a freeport and presently provides 20,000 manufacturing and entrepot jobs within the freeport and more than twice that number deriving from firms which operate within it. Because of this long history Hamburg has obtained a special derogation from the Council Directive on the harmonisation of provisions laid down by law, regulation or administrative action relating to free zones that it shall not be subject to conditions of an economic nature. This is hedged in that if conditions in a specific economic sector within the Community are affected as a result of the derogation the Council can decide that the conditions with regard to inward processing shall apply to the corresponding economic sector within the Free Port of Hamburg. On the face of it this is a valuable concession for the Free Port but as much of the industry carried on there is concerned with ship building which has special arrangements throughout the Community there has been little objection from other member states.

Shannon is the other successful zone. Founded in 1958 as an adjunct to an airport it has expanded tenfold from its original 30 acres and employs some 9000 workers in 110 companies operating within the zone. The Shannon Customs Free Airport was established on the assumption that:

(1) it would be a major European terminal for transatlantic air traffic;
(2) the carrying of passengers would be the principal business of the airline companies;
(3) cargo carried across the Atlantic by air would be offloaded at Shannon and carried on other aircraft to various destinations in Europe, and elsewhere.

For the first ten years after the Customs Free Airport Act, 1947, these assumptions proved generally correct, traffic increased and the Airport prospered. The facilities were enlarged in a piecemeal fashion as demand grew.

The development of long-range jet-engined aircraft changed the picture, and it became possible to overfly Shannon. Prospects for the Airport and all employed there looked bleak, decisions were taken to develop the Industrial Estate in the Free Airport, with the expectation that passenger and freight traffic into and out of the Airport would be stimulated by the hope for new industries and that the need for the Airport would be guaranteed. The Shannon Free Airport Company was established to develop the whole concept, advance factories were built in the industrial estate and the town was devel-

1. This report which is part of the Isle of Man Policy Planning Programme was prepared in August 1982. Note that the discussions are still in the planning stage and that no decisions have yet been taken.

oped. Tax incentives for business in the CFA were provided for in the Finance (Misc Provisions) Act 1958 and 1970. Special arrangements regarding the trade statistics of the Airport were made. When Ireland joined the EEC in 1973, the position changed again. EEC regulations and directives regarding free zones, inward processing etc. had to be considered, and the fact that non-fiscal goods from other member states were usually in free circulation changed the position radically from the point of view of revenue control of the duty-free shops. The need for the Customs Free Airport as originally envisaged was no longer significant and most of the reliefs from customs controls which it provided for were available in any event under EEC law. In addition customs control within the free zone was generally accepted as holders of operating licences came under survey to the same extent as inward processors in the State. Because of international demands for control of strategic materials, exports from the free zone became subject to Control of Exports Regulations to the same extent as exports from the State.

In the light of these developments coupled with the physical growth of the Airport Complex, the industrial estate and the town, the application of the original Regulations based on the 1947 Act became progessively more irrelevant. These regulations were based on the Land Frontier Regulations, on the theory that the Customs Free Airport was a separate enclave to which goods and people departed from the State via a Customs post, the goods being deemed to be exported, and that goods and people arriving from the Customs Free Airport were deemed to be arriving from outside the State and were processed through Customs in the same way as goods/persons imported or arriving from abroad. The practicabilities of the situation demanded however that exceptions had to be made for consumer goods, for ROB goods, for aviation fuel, mail etc. In practice, control of passenger vehicles going through the boundary posts has been minimal. Of the vehicles carrying merchandise only a proportion stopped and the remainder proceeded to their destination in the Airport proper. In addition goods consumed in the Free Airport had to be duty paid to the same extent as goods consumed in the State. The boundary posts have in fact become redundant, and with this background in mind the system of control has been changed to one of survey and occasional promiscuous checks to support the licensing regulations by which traders are allowed to operate in the zone.

Other European free zones have been less successful and there is no doubt that the meteoric rise of Shannon was due to its early arrival in the field at a time when it was the normal safe limit for transatlantic flights. Ganda to Shannon was then the norm and 50% of North Atlantic air traffic was routed through Shannon. With the extended flying range of modern aircraft Shannon might never have established itself as it did but with forward vision the government set up the Shannon Free Airport Development Company Ltd. in 1960. The zone now has a captive industrial population and many of its imports and exports are by road to the seaports. A large proportion of the companies setting up at Shannon have been from outside Ireland and there has been considerable investment from abroad.

POSSIBLE APPLICATION TO THE ISLE OF MAN

We are rather late in the day for a duty-free zone in the Island and we do not have the international air or seaport available for ready import of materials and export of finished products. There would also be opposition from the U.K. who would look upon our going it alone in this matter as an infringement of paragraph 3 to the 1979 Agreement. U.K. Customs are not in favour of Duty-Free Zones and it is most unlikely that we could reach agreement as they would not then be able to resist calls for such zones from within their own territory. They already have Enterprise Zones however and the Chancellor recently indicated in the House of Commons that he was prepared to authorise a further number. There could therefore be no objection to our having a similar arrangement.

The U.K. Enterprise Zones offer certain incentives by low cost factory units, reduced rates and assistance with equipment but they seem to be mainly aimed at moving industry from its established location within the U.K. to a new one in order to relieve various depressed areas. The Shannon incentives of tax relief, capital and training grants, and the provision of buildings etc. are similar but are mainly aimed at new industry from abroad.

We already have a low rate of direct taxation and grants are available for new industry. With customs warehousing and the inward processing arrangements already available it may be said with fairness that there is no need for a Duty-Free Zone. This is the attitude adopted by U.K. Customs in response to calls for such zones from various local authorities and even ministers from departments outside the Treasury. The Treasury ministers support Customs because of their commitment for a reduction in the size of the Civil Service and the estimated manpower cost of a zone at Prestwick being some 30 officials.

Such a staffing arrangement has been shown to be unnecessary at Shannon where, apart from the preventive/landing staff covering the airport generally, there are only four officials to cover 110 companies. On a smaller scale here we would not need more than one initially.

If we could build advance factory units on a site, preferably near Ronaldsway, for letting initially at low rents to incoming companies we could advertise world-wide a package of incentives to include:

(1) these low rents,
(2) our low taxation,
(3) stable and abundant workforce,
(4) capital equipment and training grants,
(5) easy despatch by air to Heathrow and Manchester for distribution to Europe or beyond plus Dublin for the American continent.
(6) customs warehousing, and
(7) processing arrangement.

Such a package would have a much greater impact than a generalisation of the various possibilities even though they are all available anywhere in the Island.

Given vigorous promotion I am convinced that we could attract new industry and particularly companies seeking a springboard into Europe. This new industry would not be detrimental to the industrial sector already established here which is mainly concerned with subcontracting to U.K. companies.

An additional innovation for us would be the setting up of an Inland Clearance Depot in or near the zone. This might or might not be included with the advertising package but it would have the effect of allowing goods imported by sea through the U.K. to come forward to the Island for examination. This would apply to all goods and not only to those destined for the zone. It would thus be of assistance to our present industrial sector for their imports and also as a point of departure for all exports thus avoiding delays and expense presently incurred. For these reasons it should be looked at as a matter of immediate concern whether or not the duty-free zone concept is taken up.

Should the duty-free zone idea be proceeded with it would be important that such words did not appear in the title in order to avoid offence to our partners in the EEC and particularly to the U.K. in view of the 1979 Agreement. The implication could be made in an early part of the preamble, i.e.

"THE MANX INTERNATIONAL TRADING ZONE

We are able to offer the facilities of a duty-free zone to industrial companies desiring to set up . . ."

In promoting the case for a zone of this nature I cannot do better than quote the Chairman of the Shannon Airport Development Company Ltd. when he said that given intensive promotion, an innovative approach and the availability of good support services small industry can sustain a very high rate of job creation. 1981 was a good year for Shannon when results on all fronts showed steady progress in what was a difficult recessionary year and 508 new jobs were created and the zone is looked upon as a major contribution to the Irish economy.

Perhaps a small working party could be set up with members drawn from interested government bodies such as the Treasury and Industry Board together with a representative of the Chamber of Trade, Commerce and Industry to study the possibilities.

THE EUROPEAN COMMUNITIES ON TAX FREE ZONES

On 9 September 1982 Mrs. Lizin asked the following question:

The Belgian Government, and in particular the Minister for Financial Affairs, has proposed the idea of setting up free zones in Belgium, i.e. areas where newly established industries would be exempt from taxation for several years.

Can the Commission state whether such zones exist in other Community countries? If so, which? What has these countries' experience been with such zones and what are the Community's views about them?

On 24 November 1982 Mr. Tugendhat answered on behalf of the Commission:[1]

As indicated in reply to Oral Question No. 96/82 from Mr. Radoux on 13 October, the Commission considers that a distinction should be drawn between two basic types of zones in which tax exemptions are granted:

- classical duty-free zones. Undertakings set up in such zones are exempt from import duties and indirect taxes. These measures are not normally regarded as constituting State aids contrary to Articles 92 to 94 of the EEC Treaty. They must, however, conform to Community rules on import duties (Directive 69/75/EEC) and VAT (Directive 77/388/EEC). The principal zones in the Community at the moment are the Shannon customs-free airport zone in Ireland and the freeports in Hamburg and Copenhagen;
- areas or regions where a total or partial exemption is given from certain other taxes or charges other than indirect taxes and import duties. These exemptions are usually given to promote the development of a region or a certain industrial sector, or to encourage new enterprises, or the creation of new jobs. These exemptions are usually limited to one particular tax or charge and are often linked to other policy instruments (e.g. aids or limited application of administrative procedures). Nearly all Member States have schemes of this kind which include measures such as partial exemption from corporation tax, exemption from local property taxes, accelerated depreciation, reduction of social charges, exemption from land-registration tax, etc. These measures normally fall under the ban on State aids in Article 92(1) of the EEC Treaty. The Commission may grant a derogation in respect of such exemptions provided they can be regarded as falling within one of the derogations of Article 92(3). In examining these schemes the Commission acts in accordance with its general policy on State aids. It should be noted that these types of exemption may also be granted in classical duty-free areas.

The Commission cannot be very definite about the effect of these two types of measure. Experience with classical duty-free zones is very limited, and in one instance State aids are given as well. It is therefore difficult to evaluate the effects of each measure separately. The effect of other types of tax exemption is more difficult to evaluate because they are usually given in conjunction with other aids (e.g. grants, soft loans). The Commission's general experience has led it to take a position against tax exemptions (or any other aid) that have the character of an ongoing aid. Aids in the form of tax exemptions should be in general linked to investment, job creation or restructuring plans and ensure the long-term profitability of the enterprise. Where exemptions or aids merely preserve the *status quo* the Commission has normally been opposed to them. The fact that certain types of tax exemption constitute non-transparent aids further complicates the position.

1. *Official Journal of the European Communities* No. C339 of 27 December 1982 at 12. See also 23 *European Taxation* No. 1 (1983) at 18.

PAKISTAN:

Workshop on Assessment and Related Aspects

Pakistan established within its Tax Department at the end of 1982, a Workshop on Assessment and Related Aspects.

The objective of the workshop is to train income tax officers to the requisite level of efficiency so as to enable them to tap the taxable capacity of the country and thereby to bring revenue from income tax up to par with internationally laid down standards. Training in the workshop is also a condition for promotion to tax officers to Grade-19 in the Income Tax Group. The three week refresher courses are held at the premises of the Directorate of Training, Income Tax, 15 Birdwood Road, Lahore, Pakistan.

GOVERNING BODY

Mr. Fazal-ur-Rehman Khan, Chairman (Central Board of Revenue).
Mr. Abdul Waheed, Member (IT), CBR.
Mr. A.A. Zuberi, Director (IT) Training.

DIRECTING STAFF

Mr. A.A. Zuberi, Director.
Mr. S. Mohsin Akhtar, Deputy Director - I.
Mr. Farooq A. Malik, Deputy Director - II.
Mr. Saadat Saeed, Asst. Director - I.
Mr. Mahammad Arshad Malik, Asst. Director - II.
Mr. Qamar-ul-Islam, Instructor in Accountancy.
Mr. M. Ishaq Ch., Advocate, Instructor (General Law)[1].

SUBJECTS OF TRAINING PROGRAMMES

Subjects discussed during the courses will encompass among others, the following:

1. Effective utilization of the "survey organization and its utilization".
The "survey organization and its utilization" is a kind of new experiment in gathering economic information which has tax consequences. Such information must be passed on to the authorities concerned for timely utilization by them.
2. Systematic organization of raids.
In Pakistan the income tax authorities are empowered to raid and search the taxpayers' business premises. They may also impound books/documents found on the premises.
3. Accurate evaluation of assets and investments.
4. Taxation of non-residents of Pakistan.
5. Taxation of non-residents under conventions for the avoidance of double taxation of income and the prevention of fiscal evasion.
6. Detection of concealment of income and tax fraud.
7. Transfer pricing in international business transactions.
8. Interpretation of statutes.
9. Concept of legal fiction in the Income Tax Ordinance, 1979.
10. Examination of balance sheet and reconciliation of wealth statement.
11. Inspection of files, registers and offices.
12. The judicial nature of income tax proceedings.
13. A sound appellate order - adjudication and restraint.
14. Case law, its importance, and application.
15. Prosecution and penal provisions, legal position of the parties, and procedures to be followed.
16. Genuiness of the form of an enterprise, aspects to be taken into consideration.
17. Scrutiny of books and accounts.
18. Evaluation of appellate orders for filing of second appeal.
19. Appointment of special officers and valuers, legal position and scope of duties.
20. Fiscal incentives as provided under the Income Tax Ordinance, 1979.[2]

1. See Handbook Workshop on Assessment and Related Aspects, Directorate of Training, Income Tax, Lahore, Pakistan.
2. Compare: *Workshop Newsletter*, 20 November 1982, Lahore.

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MARCH 1983

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JULY 1983

Asian-Pacific Tax & Investment Research Centre: First Asian-Pacific Tax Conference. (Shangri-La Hotel) Singapore (Republic of Singapore), July 19-20 (English).

OCTOBER 1983

British Branch I.F.A.: U.S./U.K. Seminar. London (United Kingdom), October 7 (English).

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre: 2, Nassim Road, Singapore 1025, tel. 235-1959. Telex rs 50257 aptirc (Republic of Singapore).

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen, Varnbüelstrasse 19, 9000 St. Gallen (Switzerland).

Instituto Colombiano de Derecho Tributario: Calle 16 No. 9-64- oficina 703 - tel. 2812935 - 2813951 - 2828509, apartado aereo 22726 Bogota (Colombia).

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

Institute for International Research: The Conference Administrator I.I.R. Pte Ltd, Suite 0803, 7th Floor, Golden Wall Auto Centre. Rochor Canal Road, Singapore 0718, tel. 338-3521. Telex: rs 34834 iir (Republic of Singapore).

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

Symposium S.a.r.l.: 25 rue Notre Dame, Luxembourg (Grand Duchy of Luxembourg).

Seminar Services S.A.: 1-passage Perdonnet, CH-1005 Lausanne (Switzerland).

The Taxation Institute of Australia: 113 Swanson Street, Melbourne VIC. 3000 (Australia).

CIAT APPOINTS NEW EXECUTIVE SECRETARY

The Centro Interamericano de Administradores Tributarios/Inter-American Center of Tax Administrators (CIAT) announces that on 21 January 1983 the Ciat Executive Council appointed Mr. Edison Gnazzo to its new Executive Secretary.

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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in Africa.
New York, Pergamon Press (Fairview Park, Elmsford, New York 10016), 1981. 76 pp.
A study prepared for the United Nations Evironment Programme analyzing the environmental effect on economic development in Africa.
(B. 13.130)

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Asia

INDUSTRIAL DEVELOPMENT NEWS – Asia and the Pacific. No. 14.
New York, United Nations, 1982. 96 pp.
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MANNIX, E.F.; HARRIS, D.W.
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North Ryde, Butterworths, 1982. 943 pp.
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Study of the role of prices and their effect on the industrial development policy adopted in China during the period 1961 to 1976.
(B. 51.996)

Hawaii

ALL ABOUT BUSINESS IN HAWAII.
10th Annual edition.
Honolulu, Crossroads Press (P.O. Box 833, Honolulu 96808), 1982. 76 pp.
Annual general overview of business in Hawaii. Hawaii's economy, government, real estate and taxes and major companies are discussed.
(B. 104.175)

Hong Kong

TAXATION IN HONG KONG.
International Tax and Business Service.
New York, Deloitte Haskins & Sells, 1982. 42 pp.
Booklet in the International Tax and Business Service series providing information of a general character regarding taxation in Hong Kong for those considering business in Hong Kong. The material is up to date as of 1 June 1982.
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Indonesia

BUSINESS PROFILE SERIES.
Indonesia.
Second edition.
Hong Kong, The Hong Kong and Shanghai Banking Corporation, 1982. 43 pp.
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(B. 51.986)

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Tokyo, Peat, Marwick, Mitchell & Co., 1981. 68 pp.
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New Zealand

INVESTMENT IN NEW ZEALAND.
Christchurch, Gilfillan Morris & Co. (BNZ House, Hereford Street, P.O. Box 274, Christchurch), 1981. 56 pp.
Booklet prepared for clients summarizing the forms and taxation aspects arising from foreign business operations in New Zealand, as stated in the law on 1 December 1981.
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PITAYAPORN, Mana.
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Bangkok, Thammasat University Press (2 Prachand Rd., Bangkok 2), 1980. 205 pp.
Explanation of the corporate income tax with reference to case law.
(B. 51.985)

INFORMATION HANDBOOK
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Book containing practical examples and solutions thereof with regard to another book on cost account and price policy.
(B. 104.062)

Belgium

LIEVENS, S.
Fiscaal gunstig investeren.
Brussels, CED-SAMSON, 1982. 56 pp.
Monograph providing alternative situations for investment opportunities after payment of tax (direct and indirect).
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BUBLOT, G.; FRANK, M.;BREUER, J.F.; HERINCKX, J.; LANGE, B.; LEDENT, A; PRAET, P.
Politique agricole commune. Revenus et fiscalité des agricultures en Belgique. Textes rassemblées par Max Frank.
Brussels, Editions de l'Université de Bruxelles (Parc Léopold 104, Brussels), 1982. 126 pp.
Collection of articles on income and taxation of farmers in Belgium in the light of the agricultural policy of the European Communities.
(B. 104.098)

Channel Islands

INVESTMENT IN THE CHANNEL Islands.
St. Helier, Peat, Marwick, Mitchell & Co., 1982.
43 pp.
Booklet prepared for clients summarizing the forms and taxation aspects arising from foreign business operations in the Channel Islands.
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Common Market (EEC)

INVENTORY OF TAXES LEVIED by the State and the local authorities (Länder, départements, régions, districts, provinces, communes) in the Member States of the European Communities.
Luxembourg, Commission of the European Communities, 1979. 690 pp.
General description of the tax systems of the 9 Member States reflecting the situation on 31 December 1978 (Belgium, Denmark, Germany, France, Ireland, Italy, Luxembourg, Netherlands, United Kingdom).
(B. 104.168)

BEHRENS, Carl.
Steuerberatung in der Europäischen Gemeinschaft. Schriften zur betriebswirtschaftlichen Steuerlehre.
Berlin, Erich Schmidt Verlag, 1982, 287 pp.
The development of tax consultants' organizations in the European Communities with a comparison of their professional regulations (German Federal Republic, France, Italy, the Netherlands, United Kingdom) Harmonization of tax law and regulations for tax advisers within the EEC are dealt with.
(B. 104.158)

Eastern Europe

FICZERE, Lajos; SÁRKÖZY, Tamas.
Grundlegende Rechtsfragen der internationalen wirtschaftenden Organisationen der RGW-Länder.
Budapest, Akadémiai Kiadó (P.O. Box 24, H 1363 Budapest), 1981. 224 pp., $ 18.
Book discussing the various legal aspects of international economic organizations in the member countries of the Council for Mutual Economic Assistance, with the emphasis on current developments in Hungary.
(B. 104.099)

France

FOREIGN INVESTMENTS IN FRANCE.
Levallois, Nouvelles Editions Fiduciaires (2 bis, rue de Villiers, 92309 Levallois), 1981. 148 pp.
Compilation of four topical articles prepared by various authors in French, English, German and Italian. The position for taxation purposes of chargeable persons domiciled abroad and foreign companies holding real property in France; The tax treatment of company acquisitions and some practical solutions; Takeover of a French firm by a foreign company, labour and social security law aspects; Abuse of law.
(B. 104.140)

DE PINGON, Pierre.
Fiscalité et innovations.
Brevets & savoir-faire.
Paris, Technique et Documentation (11, Rue Lavoisier, 75384 Paris), 1981. 282 pp.
Explanation of tax aspects of patents and know-how under French law with reference to the tax aspects in OECD Member countries.
(B. 104.097)

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International Tax and Business Service.
New York, Deloitte Haskins & Sells, 1982. 78 pp.
Booklet in the International Tax and Business Service series providing information of a general character regarding taxation in France for those considering business in France. The material is up to date as of 1 June 1982.
(B. 104.194)

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Paris, Editions Législatives et Administratives, 1982. 265 pp.
Study of the tax systems in France and the German Federal Republic and the double taxation treaty between both countries.
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TIXIER, Gilbert;
LALANNE-BERDOUTICQ, Daniel.
L'impôt sur les grandes fortunes. Le point après la publication de la doctrine de l'administration. Deuxième partie (Tome II).
Paris, L.G.D.J., 1982. 130 pp.
Second part of monograph explaining the new net wealth tax.
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German Federal Republic

VOGEL, Klaus; ELLIS, Maarten J., a.o.
Steueroasen und Aussensteuergesetze.
Münchener Schriften zum internationalen Steuerrecht. Heft 3.
Munich, Verlag C.H. Beck, 1981. 144 pp., 48 DM.
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MEICHSSNER, Claus.
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Book containing a comparative analysis of the tax burden on joint stock corporations and limited liability companies in major industrialized Western countries as a factor for deciding on the place of business and making other investment.
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SCHAD, Hans-Joachim; EVERSBERG, Horst; WAGNER, Jürgen.
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Anleitung und Erläuterungen zur Ausfüllung der verschiedenen Erklärungsvordrucke, einschl. der Vordrucke zur Gliederung des verwendbaren Eigenkapitals.
Düsseldorf, IdW Verlag, 1982. 392 pp., 48 DM.
Guide containing practical explanations for filing the corporate income tax return for 1981.
(B. 104.075)

RICHTER, Heinz.
Leasing im Steuerrecht Dokumentation.
3. erweiterte Auflage.
Cologne, Peter Deubner Verlag, 1982.
182 pp., 29.80 DM.
Survey of the various tax aspects of leasing in Germany. The author discusses, inter alia, German case law in this respect as well as the treatment by the tax authorities in practice.
(B. 104.002)

RICHTER, Heinz; SCHMIDER, Karl-Heinz.
Der neue Bauherrenerlass. 6 neu bearbeitete Auflage. Steuer-Telex Sonderinformation.
Cologne, Peter Deubner Verlag, 1981.
40 pp., 24.80 DM.
Special edition of the German tax periodical Steuertelex, dealing with the new administrative regulations on the tax treatment of so-called Bauherren, i.e. persons who incur the cost and risk of construction of a building.
(B. 104.202)

ERTNER, Ulrich.
Eigentumswohnungen mit Steuervorteilen als Kapitalanlage. 3. erweiterte und überarbeitete Auflage.
Herne/Berlin, Verlag Neue Wirtschaftsbriefe, 1982. 124 pp., 36 DM.
Monograph discussing the various tax privileges offered under German law for owner-occupied houses held as capital investment. The author also discusses the various legal forms of such investment (e.g. the "Bauherren-Modellen"), the tax effects thereof and the way to claim the tax privileges granted.
(B. 104.116)

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Cologne, Peter Deubner Verlag, 1982. 332 pp.
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(B. 103.985)

JASPER, Lothar Th.
Investitionszulagen zur Förderung der Beschäftigung nach par. 4b InvZulG 1982.
Cologne, Peter Deubner Verlag, 1982. 80 pp.
Commentary on the law concerning the temporary investment premium aimed at the stimulation of employment.
(B. 104.076)

SCHOPPEN, Willi.
Darstellung der Finanzlage mit Hilfe der Kapitalflussrechnung. Schriftenreihe des Instituts für Revisionswesen der Wilhelms-Universität. Band 15.
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Monograph discussing the various possibilities to determine the financial situation of enterprises on the basis of the "capital increase account".
(B. 104.073)

SCHULZE ZUR WIESCHE, Dieter.
Gewinnermittlung und Gewinnfeststellung bei Personengesellschaften.
Cologne, Peter Deubner Verlag, 1982. 174 pp., 48 DM.
Systematic survey of the problems arising in the field of determination of profits of partnerships, including the valuation of business net worth, withdrawals, non-deductible expenses, profit adjustments and others, as well as references to literature and case law.
(B. 104.001)

FALTERBAUM, Hermann; BARTHEL Klaus; STEUBER, Werner.
Steuervorteile durch Kinder. 4. vollständig überarbeitete Auflage.
Freiburg im Breisgau, Rudolf Haufe Verlag, 1982. 245 pp., 34.80 DM.
Monograph discussing the tax benefits which can be obtained by taxpayers through their children, both with respect to income tax and with respect to other taxes such as the inheritance tax and the net worth tax. The authors particularly pay attention to agreements between parents and children aimed at saving taxes.
(B. 104.119)

GLOCKER, Rainer; BÖHMER, Christof; KLEIN, Michael.
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Monograph discussing the various possibilities and the legal forms of alimony payments, life insurance, annuities, social security, etc. in the case of a divorce between spouses.
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FELIX, Günther; STAHL, Rudolf.
Erfinder in der Besteuerungspraxis. 2. Auflage. Kölner Beratungsrechtlinie 8.
Cologne, Arbeitskreis für Steuerrecht, (Aachenerstrasse 290-292, 5000 Cologne 40), 1981. 85 pp., 40 DM.
Booklet explaining the details of taxation of inventors in practice, both inventors who are self-employed and inventors employed by another person. The authors also discuss the tax aspects of the granting of licenses abroad.
(B. 104.091)

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Feiburg im Breisgau, Rudolf Haufe Verlag, 1981. 328 pp.
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Kaiser Napoleon. Deutsch-französische

Zollordnung fur das Grossherzogtum Berg aus dem Jahre 1809.
Cologne, Peter Deubner Verlag, 1982.
32 pp., 14.80 DM.
Reproduction of a document of European tax history, i.e. the German-French customs ordinance for the Grand Duchy of Berg, dating from the year 1809.
(B. 104.071)

PILTZ, Detlev Jürgen.
Die Unternehmensbewertung in der Rechtsprechnung zum Gesellschafts-, Familien-, Erb-, Schadens- und Enteignungsrecht.
Düsseldorf, IdW-Verlag, 1982. 136 pp., 58 DM.
Monograph discussing the various aspects of valuation of enterprises as developed by case law, with the emphasis on company law, family law, inheritance law and expropriation.
(B. 104.024)

SELMER, Peter.
Steuerrecht und Bankgeheimnis. Schriften zum Wirtschaftsverfassungs- und Wirtschaftsverwaltungsrecht. Band 21.
Hamburg, Joachim Heitemann Verlag (Theodorstrasse 41, 2000 Hamburg 50), 1982. 188 pp., 88 DM.
Book disucssing the position of banks in relation to taxpayers from the point of view of fiscal criminal law. The authors pay attention in particular to banking secrecy in tax matters and the obligation of banks to pass on information to the tax administration.
(B. 104.120)

SCHADE, Gerd.
Zur Konkretisierung des Gebots sorgfältiger Abschlussprüfung. Schriftenreihe des Instituts für Revisionswesen der Wilhelms-Universität. Band 14.
Düsseldorf, IdW Verlag, 1982. 238 pp.
Empirical and theoretical study on deficiences in the area of auditing. The author also makes concrete proposals to improve the situation, i.e. to meet the requirements of careful and regular auditing.
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Isle of Man

STARTING AN INSURANCE operation in the Isle of Man. First edition.
Douglas, Peat, Marwick, Mitchell & Co., 1982. 28 pp.
Information on the procedure for establishing a company and outline of the company law requirements and taxation principles on the Isle of Man. Detailed information is given on the procedure for obtaining exemption from income tax in respect of offshore business.
(B. 104.212)

Netherlands

RIJKELS, J.S.; BATEMA, R.
Beleggingsinstellingen. Eerste druk. Fed's Fiscale Brochures.
Deventer, FED, 1982. 80 pp.
Monograph on the concept and taxation of investment institutions under Dutch tax law, with reference to international operations. Relevant statutes are appended.
(B. 104.169)

RENES, J.
Het staken van een onderneming. Fed's Fiscale Brochures. Eerste druk.
Deventer, FED, 1982. 107 pp.
Monograph on the individual income tax in case of liquidation of a business or similar activity with reference to case law.
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NIESSEN, R.E.C.M.
Het begrip lijfrente in de inkomstenbelasting. Derde, geheel opnieuw bewerkte, druk. Fiscale monografieën No. 18.
Deventer, Kluwer, 1982. 209 pp.
Third revised edition of monograph on the concept of "Life annuity" under the individual income tax. An historical overview is appended as an introduction.
(B. 104.170)

VAN SCHIE, Paul;
VAN SMEDEN, Wijnand.
Samenwonen. Kluwer Belastingwijzers, No. 6.
Deventer, Kluwer, 1982. 176 pp.
Introduction to the legal consequence of living together without matrimony (income tax, death duties, social security law, buying or renting a house, children, etc.)
(B. 104.222)

VAN SIKKELERUS, W.P.
Het fiscale compromis. Tweede, herziene druk. Fiscale monografrieën No. 23.
Deventer, Kluwer, 1982. 140 pp.
Revised second edition of monograph on agreements in tax matters between taxpayer and the tax inspector in the Netherlands. Appended is a survey of the U.S. practice of closing agreements and advance rulings.
(B. 104.157)

SMID, R.J.T.
Belastingadviseur en inspecteur; Parallelle en tegengestelde belangen tussen burger en fiscus. De Nederlandse Orde van Belastingadviseurs Pre-adviezen No. 1.
Deventer, Kluwer, 1982. 71 pp.
Tax Advisor and Tax Inspector is the text of a lecture and debate at the annual meeting of the tax advisors' association "Nederlandse Orde van Belastingsadviseurs". The topic deals with the polarisation between tax advisors and tax inspectors concerning interpretations of tax law.
(B. 104.128)

Romania

GESETZGEBUNG DES rumänischen aussenhandels.
Bucharest, Champer of Commerce and Industry (22 N. Bălcescu BLvd., 79501 Bucharest), 1982. 274 pp.
Compilation of statutes relating to foreign trade and foreign investment in Romania.
(B. 104.100)

CAPATINA, O.
Zur Spruchpraxis des rumänischen Aussenhandelsschiedsgerichts. Berichte und Dokumente zum ausländischen Wirtschafts- und Steuerrecht. No. 159.
Cologne, BFAI, 1982. 42 pp.
Explanation of the arbitration practice in international trade in Romania. Relevant statutes thereto are appended in a German translation.
(B. 104.104)

Soviet Union

BERGMANN, Wilfried.
Das sowjetische Warenzeichenrecht. Berichte und Dokumente zum ausländischen Wirtschafts- und Steuerrecht. No. 160,
Cologne, BFAI, 1982. 28 pp.
Introduction to the trademark law of the U.S.S.R. by Wilfried Bergmann. The text of the statutes as amended is appended in German translation.
(B. 104.195)

Switzerland

TAXATION IN SWITZERLAND.
International Tax and Business Service.
New York, Deloitte Haskins & Sells, 1982. 70 pp.
Booklet in the International Tax and Business Service series providing information of a general character regarding taxation in Switzerland for those considering conducting a business in Switzerland.
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United Kingdom

GRAHAM, T.L.A.
Key to corporation tax. Taxation Master Key series.
London, Taxation Publishing Co., 1982. 375 pp., £ 8.50.
Reference guide to the corporation tax as amended by the Finance Act 1982.
(B. 104.191)

CORPORATION TAX.
London, Her Majesty's Stationery Office, 1982. 154 pp.
Green paper discussing the present corporation tax system and suggestions for change.
(B. 103.704)

BUTTERWORTHS YELLOW Tax Handbook. Edited by Moiz Sadikali. Twenty-first edition.
London, Butterworths, 1982. ± 900 pp., £ 16.00.
Amended text of the Tax Acts relating to income tax, corporation tax, capital gains tax as operative for 1982-83.
(B. 104.192)

TINGLEY, K.R.
Key to capital gains tax. Taxation Master Key series.
London, Taxation Publishing Co., 1982. 483 pp., £ 8.50.
Reference guide describing the capital gains tax, based on law and practice as amended by the Finance Act 1982, stating the law as in force as of 1 September 1982.
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PINSON, Barry; GARDINER, John.
Pinson on revenue law. Fifteenth edition.
London, Sweet & Maxwell, 1982. 753 pp.
Fifteenth revised edition of introductory text book to the study of revenue law, comprising individual income tax, capital gains tax, development land tax, corporate income tax, capital transfer tax, value added tax, stamp duties as stated by law as of 1 August 1982.
(B. 104.213).

COOPER, J.M.
Key to income tax. Taxation Master Key series.
London, Taxation Publishing Co., 1982. 264 pp., £ 7.00.

Annual updated edition of handbook explaining the individual income tax as of 1 September 1982.
(B. 104.160)

VAT PLANNING AND PITFALLS
London, Peat, Marwick, Mitchell & Co., 1982
125 pp.
Monograph introducing VAT planning as a concept and indicating those areas where businesses may be at risk or where beenfit may be gained.
(B. 104.210)

BUTTERWORTHS ORANGE
tax handbook. Edited by Moiz Sadikali. Seventh edition.
London, Butterworths, 1982. ± 800 pp., £ 14.00.
Amended text of the Acts relating to capital transfer tax, development land tax, stamp duties and value added tax (including VAT Statutory Instruments) as operative on 30 July 1982.
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INTERNATIONAL

VOGEL, Klaus; ELLIS, Maarten J., a.o.
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Münchener Schriften zum internationalen Steuerrecht. Heft 3.
Munich, Verlag C.H. Beck, 1981. 144 pp., 48 DM.
Book containing a number of cases with respect to the importance of tax havens and the efforts of the tax administrations of a number of Western countries to combat tax evasion through tax havens.
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MEICHSSNER, Claus.
Die Besteuerung der Kapitalgesellschaftsgewinne im internationalen Vergleich und Wege zu einer Verbesserung dieser Besteuerung.
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Cologne, Peter Deubner Verlag, 1982. 156 pp., 68 DM.
Book containing a comparative analysis of the tax burden on joint stock corporations and limited liability companies in major industrialized Western countries as a factor for deciding on the place of business and making other investment.
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IMPUTATION SYSTEMS –
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IFA Seminar Paper.
Deventer, Kluwer 1982. 45 pp.
Summaries of the mechanics of the imputation systems of Belgium, Canada, France, German Federal Republic, Italy and the United Kingdom by various authors, with an introduction by D.A. Ward.
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LATIN AMERICA

Brazil

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A tributação dos ganhos de capital das pessoas juridicas.
Comentário ao decreto-lei No. 1598/77.
São Paulo, Editora Resenha Tributária, 1978.
231 pp.
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Monograph on the tax on capital gains derived from the alienation of business assets by corporations (comment on Decree-Law 1892/81).
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139 pp.
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226 pp.
Monograph on the capital gains tax on real property acquired by individuals governed by Decree-Law 1950/82.
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Tome I, Série A à L. Recettes internes.
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Supplement to the Haitian fiscal code with annotated references thereto. Volume I contains A to L (1958-1978) of the current tax law. Volume II (L to V) is in preparation encompassing customs and communal revenues.
(B. 18.188)

MIDDLE EAST

Iraq

INVESTMENT IN IRAQ.
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Booklet prepared for clients summarizing the forms and taxation aspects arising from foreign business operations in Iraq.
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Englewood Cliffs, Prentice-Hall, Inc., 1982. 1404 pp.
Bound volume containing unabridged federal and state court decisions arising under the federal tax laws (previously reported in Prentice-Hall Federal Taxes) on income tax, estate and gift tax and excise tax.
(B. 104.216)

VERBIST, Ludovic C.
Succesvol investeren in Amerikaanse onroerende goederen.
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Monograph explaining how to invest in U.S. real property successfully. Legal and tax aspects are reviewed.
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Belgium

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Commerce Clearing House, Inc., Chicago.

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Revenue Law and Practice in the People's Republic of China

By Anne Shih and P.K. Au-Yeung

INTRODUCTION

China's attitude towards foreign trade has changed since the late 1970s. Previously, the genuine desire to do business with foreign traders was not apparent. The only door to most China traders was the Canton Trade Fair, held twice a year. The fall of the "Gang of Four" and the coming to power of Deng Xiao Ping's administration, China has set out to improve the standard of living for everyone in the People's Republic of China, and it rightly realises that this cannot be done without contributions from the outside world. Now, after the introduction of somewhat ambitious modernisation plans, there are many more avenues open to China traders who may, in most cases, freely enter into China. Foreign enterprises may support the modernisation of China through joint venture activities, the introduction of foreign technology, and the development of Chinese exports. Doing business in China is not without difficulty, however, and one of the major obstacles is the lack of a comprehensive body of written law in China. Moreover, the process of making new law is slower than most foreign enterprises are accustomed to. Although there are laws on joint ventures, income tax exploitation of offshore petroleum resources, and so on, there is still a great deal of latitude for negotiation in individual cases.

Many companies find that progress in China trade has been slow. However, they believe it will be valuable in the long run. An understanding of the Chinese legal system, including taxation, is crucial in order to judge whether to trade with China. Although the tax burden is not necessarily the most important consideration in deciding whether or not to invest, management will tend to turn away from a risky investment if a tax system creates a disincentive. Thus, it is important that business executives and consultants who plan to deepen their involvement with China be familiar with its rules of taxation.

China had no unified national taxation policy until the enactment of the "Major Rules Implementing the National Taxation System" in January 1950, which introduced 14 major taxes throughout the country. The tax system was simplified in 1953, and further simplification took place in 1958 when the Consolidated Industrial and Commercial Tax (C.I.C.T.) and the Industrial and Commercial Income Tax (I.C.I.T.) were promulgated. As a result of these changes, China had 9 separate taxes. Since 1977, the taxation system has been centralized, and the promulgation of revenue laws and their interpretation are now in the hands of the central government. China's efforts to modernize its economy were reflected in the passing of the Law on Joint Ventures in 1979, followed by the introduction of the Income Tax Laws and Regulations for Joint Ventures and individuals in 1980, and the Income Tax Law and Regulations for Foreign Enterprises in 1982.

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THE TAX SYSTEM

Tax legislation

All tax legislation originates with the Ministry of Finance. The General Bureau of Taxation within the Ministry of Finance drafts all legislation based upon its investigations and the development strategy of the country as a whole. The draft bill is then submitted to the Committee of Law of the National People's Congress, which revises and amends the bill as necessary. The final draft is then presented to the National People's Congress held annually, usually toward the end of the year. Assuming that it is approved by the National People's Congress, it is passed and published. Any changes or amendments to a tax law are made during meetings of the National People's Congress. Such changes are usually made prospectively.

The Ministry of Finance interprets the tax laws and drafts and interprets all rules and regulations.

Distinctive features of the tax system

There are 11 taxes in the People's Republic of China:

(1) Consolidated industrial and commercial tax (C.I.C.T.).
(2) Industrial and commercial income tax (I.C.I.T.).
(3) Real estate tax.
(4) Slaughter tax.
(5) Salt tax.
(6) Customs duties.
(7) Agricultural tax.
(8) Vehicle licence tax.
(9) Income tax for joint ventures using Chinese and foreign investment.
(10) Income tax for individuals.
(11) Income tax for foreign enterprises.

The last three taxes apply to individuals, joint ventures (JVs), or foreign enterprises (FE's) engaged in business activities in China either independently or jointly with the Chinese government. In principle, foreign companies are also liable for all the other taxes in existence since 1958, except the I.C.I.T., which is a tax on the profits of non-State-owned Chinese economic organisations. In practice, they may also incur C.I.C.T. (a sales tax), real estate tax, customs duties, and vehicle licence tax. (It is most unlikely that they would engage in activities involving the payment of slaughter tax, salt tax, or agricultural tax.) The Income Tax Law for FEs does not apply to JVs. Thus, taxable "persons" may be classified as individuals, JVs and FEs, each of which is taxed under a different statute.

Income tax for JVs, individuals and FEs and the C.I.C.T. will be described in detail in the rest of this paper, and the other taxes are briefly dealt with in this paragraph. I.C.I.T. is a tax on the assessable income of cooperative enterprises. State-owned enterprises are exempt from I.C.I.T. since all their profits revert to the government. Tax is paid quarterly at progressive rates ranging from 5.75% to 34.5% and a surtax of 10% to 100% of the tax payable may be charged. The real estate tax is chargeable against the owners of land or buildings and levied only in the cities. It is assessed on the value of land, on the rental value of leased premises, or on the market value of buildings occupied by owners at prescribed rates. The slaughter tax is assessed on the owner of an animal at the time of slaughter according to the market value of the animal. The salt tax is assessed on the producers of salt on a per tonnage basis ranging from ¥100 (100 yuan) per ton to ¥160 per ton. The agricultural tax is levied by the local government in kind at 15.5% of the average harvests in 1954. The vehicle licence tax is paid annually to the local government for the construction of roads. There are many categories of goods exempt from customs duties, and JVs may apply to the Ministry of Finance and Custom Department for exemption from duties on export products. Raw materials, spare parts and packaging materials used in the production of these export goods may also be exempt. Plant assets that must be acquired from overseas are also exempt from duties. The foreign shipping tax no longer exists but is partly absorbed by the C.I.C.T., which charges 2.525% of the revenue from freight, and by the FE income tax chargeable at 1.5% – giving a total of 4.025%.

Tax administration

Although the Ministry of Finance initiates all tax legislation, the General Bureau of Taxation implements and administers such legislation through its various departments, including the Foreign Tax Policy Department, Provincial Tax Department, Consolidated Industrial and Commercial Tax Department, Domestic Income Tax Department, Finance and Accounting Department, etc.

All tax returns must be obtained from the Local Tax Bureau. However it appears that photocopies are acceptable for filing purposes. Final tax returns are filed annually. However, provisional returns may be required to be filed either monthly or quarterly. Individuals who are subject to the Individual Income Tax Law are required to file monthly tax returns if they are employed by an employer outside China. If the employer is in China, it is required to withhold taxes monthly. In either case, the tax is to be paid and the return filed within the first 7 days of the following month. In addition, certain individuals who earn income outside China must pay the tax due and submit a tax return within 30 days of the end of the year.

JVs and FEs are required to file quarterly returns that are due 15 days after the end of each quarter. A final return is required within 3 and 4 months after the year-end for the JV and FE, respectively. Although the FE must make a final settlement within 5 months after the year-end, the JV must do so within 3 months. There is no apparent reason for the difference in treatment of the two entities.

C.I.C.T. has tax periods of 1, 3, 5, 10 or 15 days or 1 month as determined by the local tax authorities. Tax is paid within 3 days after the end of the tax period, except in the case of computing tax on a monthly basis, in which case, it has to be paid within 5 days after the end of the month.

Individuals are required to submit verification of amounts received each month. JVs and FEs are required to submit final financial statements with the final return. It appears that these statements must be audited by certified public accountants registered in China. Currently only accountants of the People's Republic of China are so qualified. It does not appear that such statements are required for the quarterly returns.

Although the taxpayer may calculate the amount of tax that may be due, he pays only the amount determined by the Tax Bureau. After examining the tax return, the Tax Bureau calculates the tax due, and issues a payment certificate (a bill), which is paid to the State Treasury. The Bank of China acts as the collection agent for the State Treasury. All income tax is paid in renminbi and the exchange rate is determined by the State General Administration of Foreign Exchange Control, usually on the date the payment certificate is issued.

Extensions of time for payment and filing may be obtained. The duration of the extension period will depend on the facts and circumstances. If the extension is approved, no penalties or interest will be assessed. Otherwise, a surcharge of 0.5% of the overdue tax for every day late shall be assessed.

In cases of dispute, the tax must first be paid. The dispute is first heard by the Local Tax Bureau before proceeding through the appeals process: the General Tax Bureau and Ministry of Finance. If the dispute is not resolved or if the taxpayer does not accept the decision of the Ministry of Finance, he may appeal to the Local People's Court, which makes the final decision.

The Tax Laws do not provide for any statute of limitations. However, JVs and FEs are required to maintain their records for a minimum of 15 years. There is no formal procedure whereby additions or amendments may be made after returns are filed. Apparently, a written notice is sufficient.

Tax returns are filed with the Local Tax Bureaus situated where the Head Offices of the JV and FE are registered. A similar requirement extends to individuals, that is, where they reside. If the JV and FE have branches in other cities of China, a separate return may be filed, providing the Tax Bureaus of both the Head Office and the branch agree.

Joint ventures and foreign enterprises

China does not have a general tax code or law that applies to all taxpayers. Rather it has a separate tax law for each category of taxpayer: individuals, JVs, FEs, and domestic enterprises.

The Income Tax Law for Joint Ventures was passed on 10 September 1980, and it affects those business operations that are usually classified as joint ventures. The Income Tax Law concerning Foreign Enterprises was adopted on 13 December 1981 and is effective 1 January 1982. This law affects FEs which derive income from China. It does not apply to JVs, although it does apply to joint business operations with Chinese enterprises.

The two laws contain similar provisions, but there are marked differences. Perhaps the greatest difference lies in the fact that JVs are taxed on their world-wide income while FEs are apparently taxed only on their Chinese-source income. Article 1 of the JV Income Tax Law provides that "income tax on 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." There is no such provision for FEs. Moreover, Article 16 of the JV Income Tax Law also provides for foreign tax credits: "Income tax paid by a Joint Venture or its branches in other countries may be credited against the assessed income tax of the Head Office as a foreign tax credit." There is no such provision in the FE Income Tax Law. Another difference lies in the remittance of profits. While there is a 10% withholding on remittances of profits by JVs to the foreign participant, the FE Income Tax Law provides for a 20% withholding tax on dividends paid to foreign enterprises which have no establishment in China.

JVs are taxed on income derived from production, business, and other sources. Article 2 of the "Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment" (Rules and Regulations) provides that income from production and business means income from the "production and business operations in industry, mining, communications, transportation, agriculture, forestry, animal husbandry, fisheries, poultry farming, commerce, tourism, food and drink, service and other trades". Income from other sources covers "dividends, bonuses, interest, and income from lease or transfer of property, patent right, ownership of trade marks, proprietary technology, copyright and other sources".

JVs are taxed at a flat 30% rate on such income net of expenses, costs, and deductions. In addition, there is a local surtax of 10% of the assessed income tax. FEs are taxed at progressive rates, or at a flat rate depending on whether they have an "establishment" in China. If they do have an establishment in China, the income derived from "production, business and other sources by a foreign enterprise operating in the People's Republic of China" shall be taxed at progressive rates ranging from 20% on annual income (net of expenses) less than ¥250,000 (approximately US$137,500) to 40% on income in excess of ¥1,000,000 (approximately US$550,000). In addition, there is a local income tax of 10% of the same taxable income. The tax laws are silent on the question of the special income tax rates for JVs exploiting petroleum, natural gas, or other resources.

FEs that do not have an establishment in China are taxed at a flat 20% rate on income from dividends, interest, rentals, royalties and other Chinese-source income. Such income appears to be taxed on a gross basis without the benefit of any deductions. This position is not unlike that of other countries, including the United States.

Article 2 of the "Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises" provides that "establishments" refer to organizations, places, or business agents engaging in production and business operations in China. Organizations and places include management offices, branches, representative offices, factories, and places where natural resources are being exploited and where construction, installation, assembly, and exploration are being conducted. It remains to be seen whether and how representative offices not engaged in production and business operations will be taxed. The Chinese have indicated that such offices will be examined on a case-by-case basis.

For both the JV and FE, taxable income is computed in a similar manner. There are provisions for expenses and losses. In fact, losses may be carried forward for a period not exceeding 6 years. The manner in which taxable income is computed is detailed in Articles 8 and 9, respectively, of the JV Rules and Regulations, and the FE Detailed Rules and Regulations. The allowable expenses are not unlike those deductible under the tax laws of other countries. The following items are specifically non-deductible:

- Expenditure for the purchase or construction of machinery or equipment, buildings, facilities, and other fixed assets.
- Expenditures for the purchase of intangible assets.
- Interest on equity capital.
- Income tax payments and local income tax payments.
- Penalty for illegal operations and losses in the form of confiscated property.
- Overdue fines for various taxes and penalties.
- The portion of the loss from windstorms, floods, and fire covered by insurance indemnity.
- Donations and contributions other than those for public welfare and relief purposes in China.

These items are non-deductible for purposes of both the JV and FE. In addition, there are two other non-deductible items for FEs:

- Royalties paid to head offices.
- Other expenses that are not related to production or operation.

Reasonable overhead expenses paid by an FE to its head office that are related to production and operations, and actual expenses reimbursed to its head office for services directly provided, may be listed as deductible expenses. However, they must be accompanied by certifying documents, receipts, and vouchers from the head office, together with a financial report signed by a certified public accountant. These must be examined and approved by the tax authorities where the enterprise is located before such expenses are allowable. Whether such expenditures are deductible in the computation of quarterly tax is currently uncertain.

Depreciation is specifically allowable on fixed assets with a useful life of more than one year. However items with a per-unit value of less than ¥500 and a short useful life may be listed as expenses. For the FE, in addition to these two requirements, there is a further requirement that the fixed asset cannot be the main equipment for production or operation.

Fixed assets include houses, buildings, machinery, transport, and other equipment for production or business operations. The value of the fixed asset is based on its original price. For fixed assets used as investment, the original price is the price agreed to by the parties. The original price of purchased fixed assets includes the purchase price, freight charge, installation expenses, and other related expenses incurred before the assets are put into use. There are also rules governing assets produced or assembled by the taxpayer.

The useful lives of fixed assets are detailed in Articles 13 and 18, respectively, of the JV Rules and Regulations and the FE Detailed Rules and Regulations. They range from 5 years for electronic equipment to 20 years for buildings. In general, the straight line method of depreciation is used. Other methods may be used with the approval of the Ministry of Finance.

There are also limitations on the amount of allowable entertainment expenses. For FEs, reasonable entertainment expenses may be listed as expenses within the following limits:

(1) For enterprises with annual net sales below ¥15,000,000 the expenses cannot exceed 0.3% of net sales; for those enterprises with a net sales exceeding ¥15,000,000, the expenses for the portion exceeding this amount, cannot exceed 0.1%. Therefore, a foreign enterprise with annual net sales of ¥25,000,000 will be limited to ¥55,000 in deductible entertainment expenses.

(2) For enterprises with an annual total business income below ¥5,000,000, the entertainment expenses will be limited to 1% of total business income. For those enterprises with an annual total business income exceeding ¥5,000,000, the expenses for the portion above this amount will be limited to 0.3% of such amount. Thus, an enterprise with annual total business income of ¥8,000,000 will be limited to ¥59,000.

For JVs, entertainment expenses are limited to 0.3% of total sales income, and 1% of total operational income. And, of course, only those entertainment expenses which are related to production and business, and which are backed by records and receipts, are allowable.

Moreover, intangible assets such as patent rights, technical know-how, copyrights, and trademarks may be amortized generally over 10 years unless there is a shorter useful life in which case it will be amortized over such time limit.

China grants complete or partial exemptions from taxes in order to create a favourable investment climate. Exemption tends to provide short-term encouragement through temporary fiscal benefits to new investment, rather than a long-range subsidy for operating enterprises. Income tax laws for JVs and FEs are the beneficiaries of almost identical incentive statutes. A new JV scheduled to operate for a period of at least 10 years may be exempted from income tax in the first profit-making year and allowed a 50% reduction in the second and third years. The first profit-making year is the year in which a JV has begun making profits after loss set-off. If it incurs losses in the second or third year, the incentive cannot be carried forward. For instance, Year 1 is the first profit-making year; a loss is incurred in Year 2; and Year 3 has a net profit after loss set-off. There is 100% exemption in Year 1 and 50% reduction in Year 3. The unused tax concession for Year 2 is lost. Further incentive is extended to JVs engaged in such low-profit operations as farming and forestry or JVs located in remote, economically underdeveloped outlying areas: these may enjoy a 15-30% reduction in income tax for a period of 10 years following the expiration of the 3 profit-making years. The 100%, 50% and 15-30% concessions apply to FEs, but only if they are engaged in farming, forestry, animal husbandry, or low profit activities including deep-mining operations for coal resources. Newly established FEs enjoy no such tax concessions.

The Chinese government may also exempt, completely or partially, JVs from the 10% surtax in special circumstances. Similarly, FEs engaged in small-scale production or having a low profit (annual taxable income after loss relief of less than 1 million yuan) may apply for reduction or exemption from the 10% local income tax.

In addition, a participant in a JV that reinvests its share of profit in China for a period of not less than 5 years may, upon approval by the tax authorities, obtain a refund of 40% of the income tax paid on the reinvested amount. The refund does not apply to the local surtax of 10%. It is not currently clear what form the reinvestment must take.

Individuals

Individuals in China are subject to the Individual Income Tax Law. Article 1 of the law stipulates that an individual is subject to tax on the income earned within or without China if he stays in China for 1 year or more; for individuals residing in China or residing in the country for less than 1 year, individual income tax is levied only on the income earned in China. Articles 2 and 3 of the Detailed Rules and Regulations for the Implementation of the Individual Income Tax Law elaborate on these rules, describing 4 kinds of individuals subject to income tax. They are:

(1) Individuals not residing in China; tax is levied only on income earned in China.
(2) Individuals residing in China for less than 1 year; tax is levied only on income earned in China.
(3) Individuals residing in China for 1 year but less than 5 years; tax is paid on income earned in China and that part of their income earned abroad that is remitted to China.

(4) Individuals residing in China for over 5 years; tax is paid on all income wherever earned and whether remitted to China or not.

"Residence" is important in this connection and is largely a question of fact. Dates officially stamped in the travelling documents of foreigners or stated in resident permits issued by the Public Safety Bureau become relevant. Article 2 of the Detailed Rules and Regulations provides that any individual residing for 1 year or more means any individual who resides in China for a full 365 days within a tax year which runs from 1 January to 31 December. Thus, if a person stays in China from 1 February 1981 to 31 January 1982, he is a non-resident in both tax years. A period of "temporary absence" is disregarded, but temporary absence is not defined anywhere in the law. The tax authority will normally take the following positions:

(1) If an individual is absent from China before his visa or resident permit expires and returns using the same entry document, the period of absence is considered temporary.
(2) If an individual pays repeated visits to China using either a multiple entry visa or a separate visa and there is an interval of less than 30 days between two visits, the interval is disregarded.

Income is taxed when it is received, and income that has been disposed of on behalf of the taxpayer or according to his direction is deemed to be received by him. The law is silent on deferred payments, which may be an area of negotiation on an individual basis. "Remittance" requires physical remittance, and the income tax law does not deal with constructive remittance that may be in violation of exchange controls. Income remitted from China by an individual incurs no withholding tax.

Income under the income tax law is divided into 6 categories in order to facilitate the assessment of tax:

(1) Wages and salaries, meaning wages, salaries, bonuses, and year-end extras earned from services performed in offices, organisations, schools, enterprises, undertakings and other units.
(2) Compensation for personal services, i.e. earnings from personal services in the fields of designing, installation, drafting, medicine, law, accounting, consultation, lecturing, news reporting, radio and television broadcasting, journalism, the arts, sports, and technical services.
(3) Royalties, i.e. income from transfer of patents, copyrights, the right to use proprietary technology, etc.
(4) Interest, dividends and bonuses, i.e. interest on deposits, loans and securities, and dividends and bonuses from investments.
(5) Rents, i.e. income from leasing of houses, warehouses, machinery and equipment, motor vehicles and boats, and other kinds of property.
(6) Other kinds of income specified as taxable by the Ministry of Finance.

If a taxpayer has two or more categories of income, income tax is levied separately on each, although a single return may be filed. If he is paid in kind or in marketable securities, the market value at the time of acquisition should be taken into account.

The following categories of income are exempt from income tax:

(1) Prizes and awards for scientific, technological, or cultural achievements given to individuals by the Chinese Government or by Chinese or foreign scientific, technological, or cultural organisations.
(2) Interest on savings deposits in Chinese State banks, credit cooperatives, or other banks entrusted by the State banks.
(3) Welfare benefits, survivors' pensions, and relief payments.
(4) Insurance proceeds.
(5) Military severance pay, decommission, or demobilization pay of the armed forces.
(6) Severance or retirement pay for cadres, staff members, and workers.
(7) Salaries of diplomatic officials of foreign embassies and consulates in China. Tax exemption for salaries earned by other persons in foreign embassies and consulates in China is kept at the same level as the tax exemption for persons of similar status in Chinese embassies and consulates granted by the relevant countries.
(8) Tax-free incomes as stipulated in international conventions to which China is a party or as stipulated in agreements China has signed.
(9) Dividends in investments in local construction companies in China, which pay no bonuses and whose dividends are not higher than the interest on savings deposits in State banks and credit cooperatives.
(10) Dividends and bonuses derived from JVs and from urban and rural cooperative organizations.
(11) Income from compensation for services in China if the taxpayer visits the country for not more than 90 days and payment is made by employers outside China. Failure to satisfy the 90-day test will make the entire income for the whole period of residence subject to tax. If the period of residence overlaps 2 tax years, the entire period of residence is taken into account for the purpose of the 90-day test.
(12) Incomes designated as tax-free by the Ministry of Finance.

There is no tax on pension and retirement payments. Bonuses and year-end extras are taxed in the month in which they are received and cannot be spread back. There are two noteworthy features of the individual income tax:

(1) Husband and wife are separately assessed.
(2) Each month forms a separate period of taxation.

Individuals are given an ¥800 tax-free allowance under the Individual Income Tax Law. For wages and salaries, a monthly deduction of ¥800 is allowed. For compensation for personal services, royalties or income from lease of property, a monthly deduction of ¥800 is allowed if the amount in a single payment is less than ¥4,000. For single payments in excess of ¥4,000, a deduction of 20% is allowed, but such earnings made in China by non-residents are taxed in full.

A special feature of the Individual Income Tax Law is that each month is a separate period of taxation. The monthly allowance of ¥800 is never apportioned and is given in full to a taxpayer even though he works for less than a full month. Nor can the unused allowance be carried forward to a subsequent month regardless of when earned. Income from compensation, royalties, or rents in a single payment means income earned on one single occasion or income from performance of only one piece of work, and the amount so paid is counted as a single payment.

Since bonuses and year-end payments are taxed in the month of receipt, this may push a taxpayer's income into higher tax brackets. To nullify this tax disadvantage, the tax authorities, in practice, will apply the average tax rate of the tax year to the bonuses. If the taxpayer's income is ¥800 or less in the month the bonus is received, the year-end payment is spread back over the tax year and the tax is calculated accordingly.

Each category of income has its own rate(s) of tax as follows:

(1) For wages and salaries, the tax is progressive, ranging from 5% on taxable income below ¥1,501 to 45% on income in excess of ¥12,000.
(2) For compensation, royalties, interest, dividends, bonuses, rents, and other income, a flat rate of 20% is charged.

C.I.C.T.

C.I.C.T. is a sales tax adopted by the National People's Congress on 13 September 1958. All entities and individuals engaged in the following activities are subject to C.I.C.T.:

(1) industrial production,
(2) agricultural purchasing,
(3) importing,
(4) retailing,
(5) communications and transport, and
(6) the rendering of services.

C.I.C.T. provides that the following are exempt from tax: business receipts of State banks, insurance enterprises, agricultural machinery centers and medical and health care institutions; and the revenue of scientific research institutions derived from experiments.

Products manufactured by an industrial enterprise and used by it in further production are not subject to tax. However, such products used for capital construction rather than in further production are subject to C.I.C.T.

Tax is computed at the applicable rate based on the revenue received, except for importation of foreign industrial c.i.f. price of the goods, customs duties, and the C.I.C.T. itself. C.I.C.T. is an allowable expense in arriving at the taxable income of JVs and FEs. Tax reductions or exemptions may be available if tax incentives are needed.

A schedule of taxable items and tax rates has been adopted by the tax authorities. Industrial products not included in the list are subject to 5% while agricultural products not listed in the schedule are not subject to tax but only taxed at the retail level. At the retail level, an additional C.I.C.T. at 3% is charged.

For communications and transportation, including mail and telecommunications, railways, air transport, shipment, loading and unloading, trams and public buses, C.I.C.T. is assessed at a flat rate of 2.5%. For services, there are three rates of tax, namely, 3%, 5% and 7%, based on the type of service.

Practical problems

Since the tax laws are relatively new and since the Chinese themselves are learning through experience, foreigners may find it frustrating since there are no ready answers to questions nor are there any published rulings or cases, or precedents from which tax affairs may be guided.

Moreover since each case may form a precedent for later cases, it appears the Chinese are taking a stricter and more narrow approach in interpreting the tax laws. In a recent case, the Chinese required receipts for all expenses regardless of the amounts involved.

The laws have been written with flexibility in mind. However, in achieving this aim, they left many issues unanswered, with the result that many potential investors will not know the full extent of their liability to Chinese tax until after the fact.

CONCLUSION

The effect of the various tax measures adopted by China in recent years is not yet known. China prefers to have a tax system that is simple and easy to administer, and the tax laws have been written with this in mind. Tax authorities are given great discretion in arriving at decisions. It is believed, however, that a sound tax system should contain clear definitions of the terms used. Also, China has yet to issue comprehensive accounting standards that are acceptable for tax purposes.

China's tax system tends to encourage foreign investment and the import of technology, but tax incentives should preferably be on a long-term planning. Moreover, there should be coordination with capital exporting countries through tax treaties. In fact, China is currently negotiating tax treaties with some western countries.

The tax laws in China compare favourably with those of most major countries. Certainly the laws leave many questions unanswered, but these will undoubtedly be resolved as China gains more experience and skill from implementing them.

Tax Treaty Shopping

By Robert J. Patrick, Jr.*

From their beginnings, there has been a recognition of the tension between designing income tax treaties to promote the flow of international investment and the problem of tax administration and tax avoidance or evasion. The Financial Committee of the League of Nations in a report to the League Council on 8 June 1925 made the following statement with respect to a proposed conference to draft a model income tax convention:

> The Financial Committee strongly urges that the future Conference should, while seeking to provide a remedy for tax evasion and double taxation, take into consideration the disadvantage of placing any obstacles in the way of the international circulation of capital, which is one of the conditions of public prosperity and world economic reconstruction.

As recently as the publication of the Commentary on the revised 1977 OECD Model Double Taxation Convention, which followed a decade of revision of the 1963 model, the OECD Committee on Fiscal Affairs emphasized the difficulty of the problem:

> The Committee on Fiscal Affairs has examined the question of the improper use of double taxation conventions but, in view of the complexity of the problem, it has limited itself, for the time being, to discussing the problem briefly in the Commentary on Article 1 and to settling a certain number of special cases (paragraph 2 of Article 17 and Commentaries on Articles 10, 11 and 12). Besides, Article 26, as clarified in the Commentary, enables States to exchange information to combat improper use of conventions, tax avoidance and evasion. The Committee intends to make an in-depth study of such problems and of other ways of dealing with them.

As tax matters go, income tax treaties, until recently, have not been very visible. I think that this has been because they have been fairly simple in substance and administration. Their benefits have been taken as a matter of course and with the assurance of certainty, e.g. that withholding rates are automatically treaty rates. The interaction of certain treaties and internal tax laws have, of course, assumed considerable significance for tax planning and it seems to me that it would be those specific treaties that would be the focus of policy review. That does not appear to be the case from the U.S. side. Instead, a long-term project is underway to develop treaty shopping rules of general application to all treaties. These proposals, reflected in several drafts of a proposed Article 16, can significantly affect the role of treaties and their administration as applied to all international trade and investment by removing the certainty and by imposing significant administrative burdens.

I believe that it is useful in assessing the current U.S. approach to separate two issues that are being mixed together. The first issue is of general application to all treaties, and it is how to deal with fraud in claims for treaty benefits. Certainly, access to information is a critical need for tax administration and there should be continued efforts to improve such access to deter fraud. Moreover, I believe that withholding procedures can be developed to give both treaty partners a mutual incentive to monitor the validity of claims by persons claiming treaty resident status.

The second, and more difficult, issue in the present U.S. approach is that of the status of bona fide corporate treaty residents who are owned by third-country investors. There are those who do not view this phenomenon as a problem. Indeed, it is inevitable in a world of multilateral investment and trade that treaty benefits will flow indirectly beyond the borders of any two countries. The more treaties a treaty partner has, the more pronounced this effect will be. Most significant is the fact that the detailed economic tax policy decisions that went into drafting model treaties basically did not focus upon what today is called "treaty shopping". Tax treaties were indeed written in bilateral form, but a fundamental rule was that a company resident in a treaty country was entitled to the application of the treaties of that country. Such a company would often have foreign as well as domestic owners and creditors. Thus, even in the absence of multilateral treaties, the present system has permitted a flow of investment and business organization substantially unencumbered by cascading income taxes and regulatory burdens. There was generally no effort to fine tune treaties and there was recognition of practical restraints upon the capacity of treaties to be purely bilateral in their operation. William James, the American philosopher, had once observed that: "The art of being wise is the art of knowing what to overlook". Verification of the fact that income was flowing to a bona fide corporation resident in a major commercial country was generally deemed sufficient inquiry.

It now seems clear, however, that although they may differ in defining the objectionable cases, there is a growing perception among tax administrators that there is an issue of third-country beneficiaries that should be addressed. The Committee on Fiscal Affairs quite correctly perceived that the tax policy issues in identifying what constituted treaty abuse and developing arguments on rules to counter such abuses required an effort of major proportions. It is an effort that should be undertaken with careful deliberation.

While a number of comments can be made, there are three points that I would like to make concerning the U.S. approach: (1) to direct attention to the problem that abuse rules are of primary interest to the source country and that this is not overcome merely by imposing more qualifying tests; (2) to note the fact that up until now subsidiaries have been able to rely on the treaty network of the country in which they are resident; and (3) to make the argument that comprehensive anti-abuse rules should not be included in all treaties, but only as specific problems arise in a bilateral context.

* *Robert J. Patrick, Jr.,* Jones, Day, Reavis and Pogue. Excerpts from the remarks made at the Joint Meeting of the Netherlands and U.S. Branches of the International Fiscal Association in New York City on 10 September 1982.

ADMINISTRATION OF ABUSE RULES

One of the fundamental questions that does not appear to have been addressed is the absence of interest of a tax treaty partner in enforcing anti-abuse provisions for the benefit of the other treaty partner. There is a burden that is imposed on an administrative system in collecting taxes or monitoring treaty benefits on behalf of the other country where enforcement will not result in revenue collections for the enforcer. Thus, even those proposals that would require certification for beneficiaries of treaty benefits are subject to this lack of incentive. One result is either a loose system of monitoring as in the U.S. address system or the other extreme of a refund system with delayed refunds to foreign investors that discourage international investment. It might be possible, however, to construct a bilateral treaty withholding system in which immediate refunds are claimed not from the source country, but by the recipient of the income from the authorities in his country of residence, with the latter settling accounts periodically with the source country. This method would give both countries a greater stake in identifying whether claimants of treaty benefits are bona fide residents while avoiding delays in refunds to investors.

PROTECTION OF SUBSIDIARIES

There has been recognition for many years that income tax treaties are deficient in sorting out the taxation rights and double taxation relief in the case of branches of foreign corporations located in a treaty country. Prior to the proposals for Article 16, subsidiaries located in a treaty country have generally benefited from that country's treaties on terms equal to any domestically-owned company. The thrust of Article 16 is to change this result with respect to companies that are not domestically-owned by providing special tests and inquiries that may not be able to be satisfied. This suggests that if such a policy is to be pursued, the draftsmen should also focus upon the difficult issue of whose responsibility it will be to relieve double taxation. For example, if dividends flowing from the U.S. to a German company are not to be at a reduced rate because the German company is a joint venture that does not meet the required German individual ownership test under the treaty, then what country or countries should provide relief from the cascading taxation that may result?

SPECIFICALLY TAILORED RULES

I submit that whatever one's judgment as to the existence and scope of the problem, it is a mistake to try to address this issue through new, comprehensive tax treaty rules for all treaties. In some instances, a specific treaty limitation may easily resolve a problem by reference to the tax law of a treaty partner country, but as illustrated by Article 16, the questions that are raised by broadly applicable rules covering all investments and transactions make a broad regulatory scheme difficult to apply. It is acknowledged by U.S. officials that the substantive rules and procedures necessary to administer such an approach must be tailored in any event to bilateral situations. This will mean that there will be a variety of substantive rules and administrative procedures for every country in dealing with its treaty partners. Such cumulative rules will be of a greater order of complexity than heretofore existing treaty rules.

Treaties should not be used to make up for what is an underlying deficiency in the internal laws of a country that wishes to participate in a treaty network. The solution to problems perceived to exist by a tax administration should be resolved by selectivity in choosing treaty partners; by determining whether or not specific concessions will be made on withholding rates or other treaty provisions based upon whether such a concession would lead to unacceptable distortions in investment decisions; and by negotiating treaties with only limited concessions or granting concessions only when they are linked to a decision by the treaty partner to modify its internal laws to reduce the potential for distortion. There are previous examples of both the Swiss and Canadian Governments responding to the concerns of other countries over the use of their treaties by non-residents. This alternative approach will, in some cases, lead to difficult general negotiations. Yet it means a wiser course than writing rules of general application such as those in proposed Article 16 that are difficult to apply to the vast number of normal transactions in the daily conduct of international trade and business.

In next issues:

Tax ratio and effort analysis: A critical evaluation
– by *M.M. Ansari*

Sales taxation in OECD Member Countries
– by *S. Cnossen*

Canada: The 1982 changes to the taxation of international income
– by *A.R. Lanthier*

United States: Controlled foreign corporations – A victory for taxpayers
– by *P.E. Soos*

Attempts to Curb Treaty Shopping in U.S.–Dutch Treaty Negotiations

by R.D. Kramer

Last year a group of Dutch tax law firms, banks and accounting firms alerted the Dutch Ministry of Finance that severe damage could be inflicted upon the Dutch position as a financial center if an anti-treaty shopping clause, like one of the various versions of Article 16 of the U.S. Model Convention, were to be adopted in a tax convention between the United States and the Netherlands.

If groups of interested parties organize themselves to protect their interests, one runs of course the risk that even reasonable arguments are viewed with a certain suspicion, as an oratio pro domo rather than as a worthy contribution to a serious problem.

Indeed I think that there is reason for this suspicion, because why did we not object when the principal purpose clause was inserted in the Dutch-Swiss treaty? Or when the Luxembourg holding company was excluded from the Dutch-Luxembourg treaty, was it not that because these provisions were less harmful to Dutch financial interests compared to what has now been presented to us by the United States?

It was only when we were more or less caught by surprise by the new Dutch–U.K. tax convention that serious criticism was given, especially because of the fact that the severe overkill effects in this treaty do harm Dutch financial interests.

Although I therefore have to admit that there may be an element of truth in this accusation, I nevertheless feel that it should be disregarded, because there are much firmer grounds for our opposition to Article 16 than self-interest.

The phenomenon, which in Anglo–American terminology is described as treaty shopping and which in the Netherlands is described as abuse or improper use, or, less derogatory, unintended use of tax conventions, is not easy to define.

In a recent article I tried to describe this phenomenon as follows: it is the line of conduct of taxpayers, including the creation of structures whereby new taxpayers come into existence, as a result of which such infringement is made on the appropriate and intended scope of a tax convention, that in the situation as created treaty benefits should be withheld.[1]

I am certainly not convinced that this is a very good definition and anyway it is extremely vague and gives rise to many questions. It requires a search into the leading principles which govern the relationship between sovereign nations in the tax area, if in fact there are any such principles.

There has been an interesting discussion in the Netherlands between two distinguished tax scholars, one of them arguing that tax principles no longer fit in modern western society because taxation is an inseparable part of the social and economic system, whereas the other argues that indeed we need proper taxing principles which should not be subject to rapid and easy change.

There is a certain resemblance here to the discussion of whether tax law exists at all or whether one can only talk of tax policy. It is beyond the scope of my contribution to this seminar to go into this question from a national tax point of view. From an international point of view I believe, and in fact I regard it as an absolute necessity, that generally accepted principles of international tax law are applied and if necessary further developed.

Of course these are of a different nature than on the national level. On the national level the taxing principles, if any, affect the relationship between government and taxpayers, whereas on the international level they affect behavior among sovereign nations vis-à-vis each other in cases where their systems overlap each other and give rise to double taxation of their tax subjects.

I have understood that here in the United States various arguments have been put forward by those who wish to put an end to treaty shopping.

The first, of course, is very down to earth but very important: the loss of revenue.

The second is that U.S. tax legislation provides for a tax on certain categories of income which are paid to nonresidents, e.g. dividends, royalties and interest, and it would be a violation of the law if as a result of the conclusion of a treaty with one country this taxation were to disappear vis-à-vis all sorts of residents of countries which have not or not yet concluded a tax convention with the United States.

With respect to the first argument, loss of revenue, I would like to say that presumably revenue gains and losses and the balance of these two cannot even be estimated at the moment of concluding the convention. But if this were possible and if the contracting partners could conclude a tax convention whereby ideally at the moment of conclusion they bring an equal sacrifice, they know that from then onwards gain and loss will vary from day to day. Gain and loss from tax conventions are only one consideration in deciding whether a government wants a treaty or not and presumably not the most important one. Imagine that also as the result of a treaty between countries A and B an important flow of investments starts from A to B, which improves B's balance of payments, finances its industry and creates labor opportunity, but which also gives rise to an increased flow of dividends and interest from B to A. Would we then re-

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1. Kramer, R.D. "Oneigenlijk gebruik van belastingverdragen" in 110 *Weekblad voor Fiscaal Recht* 5524 (1981) at 1357.

gard it as fair if B wished to terminate the convention because as the result of this increased flow of funds its revenue loss exceeded that of A?

A tax convention in my opinion could not and should not be regarded as a quid pro quo arrangement on a strictly bilateral basis. It is not some sort of a profit and loss statement, it is much more an instrument in which internationally accepted allocation rules are agreed upon.

Besides I don't know whether anyone has ever attempted to make quantitative studies of U.S. revenue losses as a result of treaty shopping. It seems to me that these are very difficult to make because of too many variables, but if it were possible I would not be surprised if the outcome were contrary to what is feared, no revenue loss but a revenue gain and also a gain for the U.S. economy.

In this respect it is very illustrative that I have been informed that high ranking U.S. tax officials are of the opinion that if the withholding tax on interest could not be abolished, the United States must have a treaty with, for instance, the Netherlands Antilles because it cannot afford to cut itself off from the Euro-dollar market. This seems to me a rather cynical approach because there should be no double standards for governments and ordinary taxpayers.

I come to the second argument: U.S. taxation of residents of all sorts of countries should not disappear as a result of the conclusion of a treaty with one particular country.

This sounds reasonable and convincing and certainly provides an excellent banner for U.S. negotiators to march behind. But the many crusades in history teach us that so often, behind a banner and in the name of a slogan, much injustice has been inflicted upon innocents.

Behind banners you can always find simplifications and here the simplification is the assumption of transparency of legal entities.

Mind you, both the United States and the Netherlands apply the classical system of double taxation. Taxation at the corporate and individual levels implies non-transparency of legal entities, but here suddenly the United States introduces the concept of transparency for corporate residents.

Based on the above, I am of the opinion that these two arguments which have been put forward in the fight against treaty shopping show serious weaknesses upon careful examination.

A third argument which is often used is that third countries may become less eager to enter into a tax convention with the United States if their residents already have been able to remove the burden of double taxation or high withholding tax burdens by using treaty shopping structures.

To be honest, I cannot judge whether or not this argument is very meaningful and I do not know whether negotiating teams have ever experienced that this was to their detriment.

It seems to me, however, that its significance should not be exaggerated. When we look at the important capital streams in the world and we look at the pattern of tax conventions, the most important area which is more or less void of tax conventions and which nevertheless participates very strongly in these capital streams is the Middle East.

However, the absence of tax conventions between the Middle Eastern countries and the industrialized world cannot be explained by the fact that their residents are able to help themselves by treaty shopping but mainly by the fact that their tax systems and revenue services until now have been slightly less sophisticated. I may add that probably the absence of conventions with the Middle Eastern countries has been to their own disadvantage and certainly not a disadvantage for the United States and European countries.

By putting question marks to the arguments put forward against treaty shopping I am aware of the fact that I run the risk of creating the impression that I am here to defend even the most provocative cases of treaty shopping. That is not true. I believe that no competent tax man, whether on the government side or in private practice, would wish to defend a case like your Aiken case for better or worse.[2] I believe that it is perfectly reasonable that the best efforts be made to render such provocations more difficult.

However, in my opinion, these efforts should in the first place be made in the national tax legislation and jurisprudence. In fact, in the Aiken case it was not necessary to alter a tax convention. The U.S. tax court did not need that at all to come to its decision in favor of the I.R.S. In the U.S. national tax legislation, more than in practically all other countries, provisions have been inserted which render the use of foreign jurisdictions useless. Of course I have in mind here the subpart F and CFC legislation, whereas as a result of FIRPTA the United States is well under way to the same result in the area of U.S. immovable property held by non-U.S. residents.

But if ultimately a desired solution could only be found by inserting the necessary provisions in a tax convention where sovereignty of another nation also comes into the picture, it is a vital condition that one should not infringe upon a number of principles with respect to the negotiation of tax conventions, even at the price of having to accept certain imperfections.

When I say principles I know that I expose myself to criticism by those who are of the opinion that a tax convention or the renegotiation of a tax convention is a technical matter only, but whether you call these principles or just a set of rules may not make a major difference.

What, then, are these principles or rules which I think we should value so highly in the relationship between the nations?

First

Respect for each other's sovereignty. I am aware that this is a very general rule which speaks for itself. Nevertheless it is important. A great philosopher of international law has called the concept of sovereignty the quicksand on which the foundations of international law are built. Nevertheless, quicksand or not, sovereignty must be the basic starting point. The Netherlands for historical or other reasons may have tax conventions with other countries than the United States has, but just as it is the sovereign right of the United States to decide with which countries it wishes to have tax conventions, it is also ours. Of course a country may decide that it does not

2. U.S. Supreme Court, 56 T.C. 925 (1971).

wish to have a treaty with the Netherlands even at the price of the unjust double taxation which could result for a number of its residents, but once parties are sitting together and wish to negotiate a treaty there are certain areas with which each of them has to deal within his own sovereign right, and which must be respected by the other.

Apart from that, the Netherlands has always shown its willingness to apply guidelines which are agreed upon on a multilateral basis, e.g. in the OECD framework. If and to the extent that the Netherlands still has lower withholding rates in certain treaties than those recommended by the OECD, as a result of which the Netherlands may have been found attractive for international operations, that may certainly not be regarded as a deliberate policy to render oneself attractive for such operations. On the contrary, I have reason to assume that the Netherlands in their renegotiation programs with, for instance, the Netherlands Antilles and Switzerland will try to increase these rates at least to OECD recommended levels.

Second

Respect for each other's tax system. The pros and cons of a credit system versus an exemption system are well-known to all of you. I don't think that there is any reason to regard a credit system as inferior to our exemption system, but neither is there any reason to regard it as superior.

Our exemption system is built on very solid principles of taxation and in one way or another it has existed for almost a hundred years. I would like to deny with much emphasis that for that reason the Netherlands could be regarded as a tax haven. Such a statement is just as wrong as the statement that the United States is a tax haven for the reason that they tax, for instance, so-called 80/20 companies or the profits of a DISC in a different way.

Third

Respect for each other's economic situation. The Dutch economy is a very open economy which depends heavily on international relationships. The chances that a Dutch company has or in the future will have non-Dutch shareholders are far greater than that a U.S. company has non-U.S. shareholders. To deny treaty benefits to Dutch companies because of third country resident shareholders would damage now and in the future many Dutch companies in a totally unjustified way. The complete rejection of overkill consequences in my opinion deserves major emphasis.

Fourth

The principle of non-discrimination. Certainly a treaty should have good definitions concerning private and corporate residence. But once it has, non-discrimination should be among them.

I admit that during the past decades, thanks to improved communication and transportation facilities, the world has become much smaller than it used to be. Maybe the concept of residence for corporations and individual persons has to be redefined - and that is where a solution may be found - but once residence has been defined and established, both in the national legislation and under treaty provisions, that should be it. We should certainly avoid the situation that all residents are equal but some more equal than others.

Finally, and that may possibly not be regarded as a principle but nevertheless it is very important, I would like to say that we should be very careful not to destroy what has been developed during the past 50 years or so in the area of international tax law, for instance, on the OECD level.

The OECD is studying the question of what can be done against provocative treaty shopping and, quite rightly, they also pay attention to the importance of international capital movement and the necessity to prevent injustice caused by overkill provisions. I fail to understand why the United States is now forcing this issue by imposing its own U.S. model on treaty partners. I fear that its reasoning, as it appears to be, is influenced too much by the desire to destroy the practices of tax criminals, narcotics traffickers and so on.

Here of course I refer to the report submitted by Mr. Richard Gordon which puts much emphasis on these criminal practices and which also has some drastic recommendations, e.g. prohibiting U.S. airlines to fly to certain designated tax havens.

This however, has nothing to do with proper or improper application of tax conventions or proper or improper tax planning of the international business community. It confuses and even pollutes the issue.

I summarize. Treaty shopping is very hard to define. Those who wish to put an end to it or to its most challenging forms should carefully judge the validity of their arguments because these arguments, although at first appearance very persuasive and reasonable, are doubtful in many respects. Those who are against anti-shopping provisions may be motivated by vested interests but, more important than that, there may be genuine concern that carefully developed rules or principles are put aside which could ultimately wholly or partially defeat the purpose of treaties itself.

On the march against treaty shopping, one should be aware that ideally it could be terminated by an identical world-wide treaty network. Although that is a constructive approach, clearly for the time being it is Utopia. It could also be terminated by the absence of treaties through splendid isolation, but that would be destruction of what has been achieved over a long period of time and a return to international tax anarchy.

In between, indeed, there are imperfections with which we may have to live.

I quote a distinguished European tax scholar, the German Dr. Debatin, who once in a seminar explained the Swiss-German treaty and German foreign tax law and who said:

> If we could wish to remove all imperfections we would have to build a wall around all of Germany, comparable to the wall in Berlin, but I am sure that in doing that we would sacrifice greater value than whatever value we are trying to get out of it.

It is for that reason that I am of the opinion that the United States should not have presented to the Netherlands their various versions of Article 16 and that they should withdraw these for very serious reconsideration.

European Communities: Unfair Trading Practices[1]

On 27 August 1982 Mr. Michael Welsh submitted the following question to the E.C. Commission:

It is alleged that various newly industrialized countries use a number of devices to promote exports of textiles, clothing and footwear to Community countries. The following are examples:

South Korea

"Export-friendly" taxation permitting 60% remission of indirect taxes for exports.
Promotion of foreign investments by substantial tax reductions.
30% additional depreciation allowance for companies engaged in exports.

Taiwan

Tax exemption for five years for new enterprises in the textile industry.
Reduction of tax on capital yields from 35% to 15% for certain favoured industries.

India

Five-year tax exemption for new enterprises with further five-year extension if capacity is increased.
Unlimited carry forward of normal depreciation allowance, possibility of special write-off of up 35%, ability to carry forward losses for up to eight years.
Costs incurred in developing export markets deducted up to 150% for tax purposes.

Brazil

Reduction of rate of profit tax on export earnings and possibility to invest up to 50% of the amount due on this tax in export promoting activities.
Deduction of export share of tax due on profits so as to make it economic to export at cost.

Tunisia

Up to 10 years exemption from 90% of profits tax for exporting industries.
Exemption from capital yields tax for up to 20 years on export investment.

Singapore

90% exemption from tax on profits resulting from exports for up to 15 years.

Thailand

Up to 90% exemption from turnover taxes and halved tax on profits for export industries.

Philippines

25% of export profits to be deducted for tax purposes for the first five years.

1. In general terms, is the Commission aware of these incentives and can they confirm they exist?
2. Which Community Member States offer similar incentives to exporters
(a) for intra-Community trade;
(b) for external trade?
3. To what extent has the Commission discussed these practices with trading partners in the framework of the different trade and cooperation agreements?
4. Does the Commmission regard the existence of such practices as the principal argument for the prolonging of the Multifibre Arrangement and the development of other orderly marketing arrangements?
5. In the light of this, will the Commission seek to include the question of tax incentives for exporters on the agenda of the GATT Ministerial meeting?
6. Does the Commission agree that, for an initiative along these lines to be successful, there would have to be a Community Regulation defining which export incentives are permissible and which constitute unfair trading?
7. Does the Commission plan to make proposals for such a Regulation?

On 14 January 1983, Mr. Haferkamp replied on behalf of the Commission:

1. In view of the detailed nature of the question referring to the existence of preferential measures available to newly developed countries concerning the textile, clothing and shoe exports to Community countries, the Commission, being aware that several suppliers use export promotion devices, is at present examining the situation in detail and will reply when in possession of more information.

2. (a) According to the Commission's unchanging position, consolidated by decisions of the Court of Justice, export aids in trade between the Member States are incompatible with the common market within the meaning of Article 92(l) of the EEC Treaty and do not qualify for any of the derogations provided for in the other paragraphs of that Article. All export-promoting measures likely to contain elements of aid are constantly investigated in detail by the Commission in order to check their compatibility with the Treaty rules on State aids.
(b) The Commission has no knowledge of such facilities.

3. These matters have been discussed with partner countries particularly in the course of the recent negotiations for the renewal of the bilateral textile agreements. The Commission continues to pursue these matters and will inform Parliament of the results.

4. The Community's policy in respect of imports from countries which are contracting parties to the Multifibre Arrangement is based chiefly upon the cost advantages enjoyed by producers in these countries. The components in the "low cost" factor are numerous; while the wage levels prevailing in these countries are generally a major factor, incentives of the type referred to by the Honourable Member are certainly another factor.

5. The Commission did not seek to include the matter on the agenda of the recent Ministerial meeting of GATT, so as not to effect the negotiations already being held. This question could be placed on the agenda for a future meeting.

6. and 7. The Commission does not at present intend to propose such a Regulation.

1. 26 *Official Journal of the European Communities* C 43 (1983) at 4.

Sales Tax Controversy in India: An Evaluation

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I. INTRODUCTION

Sales tax is a source of revenue for the states in India. Although it was first levied as an alternative to the state excise duties on liquors in the wake of the demand for introduction of prohibition, it has grown into an independent as well as a very elastic and lucrative source of revenue for the state governments. This is evident from Table 1 which shows that the total yield from sales tax constitutes 25% of the total revenue, 37% of the total tax revenue and as high as 65% of the indirect tax revenue of all the states in India. In fact the state governments' finance would have been in total chaos but for the buoyancy of the sales tax in an inflationary situation.

Along with this fiscal importance, the operation of sales tax has also given rise to several problems in the fiscal structure of India. The sales tax rates differ from state to state on the same commodity; the exemption limits of dealers' sales turnover for tax purposes are not uniform; the procedures of assessment vary and the administrative set-up is also not uniform across the states. The diversity in the structure of sales tax in operation in India is summarised in the Appendix. Further, because of the free movement of goods across the state boundaries, large scale evasion of sales tax on inter-state trade has compelled the state governments to resort to certain inconvenient methods of assessment such as the creation of check-posts at state borders. Furthermore, the inflationary situation in the country, partly due to frequent hiking of the rates of sales tax (which are mostly ad valorem), has created a negative reaction among the public in the form of resistance to rate hikes because sales tax pushes up prices. Such a reaction makes tax evasion easy for dealers in collusion with the consumers. All these factors have led to the demand for the Central Government to take over the power to levy sales tax and to replace it with additional Union excise duties. A Committee has been constituted to go into this issue and make recommendations. It appears as though the sales tax is going to be gradually replaced by Union excise duties. If this ever happens, it will have serious financial implications for the state governments. Therefore, it may be rewarding to examine the reasons behind the demand to replace the sales tax with additional Union excise duties against the background of the evolution of sales tax in India.

II. HISTORICAL BACKGROUND

Even before the introduction of provincial autonomy in India, a tax on the sale of electricity was levied in the former province of Bengal. Following this example, a similar tax was levied in the former Bombay, Sindh and Madras provinces. After implementation of the Government of India Act of 1935 in the provinces, existing at time, the provincial governments of the Central provinces and Madras levied sales tax: the Central provinces on the sale of petrol and lubricating oil in 1938 and Madras province levied a general sales tax in 1939. These attempts sparked off a conflict between the Government of India and the provinces. Under Section 213 of the Government of India Act of 1935, the Government of India questioned in the Federal Court the legality of the Sales of Motor Spirits and Lubricants Taxation Act of 1938 passed by the legislature of the Central provinces. The Government of India contended that an excise duty could be levied at any stage between production and consumption and therefore the sales tax levied by those two provinces was in effect excise duty. The provincial sales tax in question was thus an invasion of item 45 of the Central List of the 1935 Act. But the provinces concerned maintained that excise duty was a tax levied immediately on production and at any stage up to the time of the first sale but not thereafter.

Sales tax distinguished from excise tax

The Federal Court unanimously agreed with the point of view of the provinces and declared that the disputed Act of the Central provinces was in order. Thus the judgement of the Federal Court drew a line of demarcation between excise duty and sales tax. According to this judicial distinction, excise duty is a tax on goods which are produced and therefore is a tax on production and not on sales or proceeds from sales. Excise duty has proximity to the point of production whereas the sales tax has proximity to the point of sale or consumption.[1] This view has been endorsed by the Supreme Court of India in a later judgement on a similar case:

> The taxable event in the case of the duties of excise is the manufacture of goods and the duty is not directly on the goods but on the manufacturer thereof. We may in this connection contrast sales tax which is also imposed with reference to the goods sold where the taxable event is the act of sale. Therefore, though both excise duty and sales tax are levied with reference to goods, the two are very different imposts. In one case, the imposition is on the act of manufacture or production while in the other it is on the act of sale.[2]

This narration of the judicial history of sales tax in India is intended to show the contrasting judicial opinions expressed on the same issue in Australia and India. In Australia, the High Court (which is the counterpart of the Supreme Court of India) has held that sales tax is also a form of excise levy and therefore should be levied by the Commonwealth Government instead of the state governments to which it was implicitly allocated by the Australian Constitution as a residual source of revenue. Whereas the Indian judicial decision seems to be reasonable from the point of view of the financial autonomy of the states, in terms of economic logic the Australian judgement seems to be sound and wise. The Indian judicial opinion protected the financial autonomy of the

Table 1
Revenue from sales tax in India

Year	Total yield from sales tax (million rupees)	Sales tax yield as % of total revenue of the states	Sales tax yield as % of total tax revenue of the states	Sales tax yield as % of total indirect tax of the states
1951-52	589.0	14.86	25.87	33.96
1952-53	572.0	13.60	24.60	34.01
1953-54	657.0	14.06	25.53	36.31
1954-55	737.0	15.70	27.74	39.54
1955-56	815.0	14.71	28.88	41.95
1956-57	976.0	16.32	30.72	43.49
1957-58	1,172.0	16.47	32.92	45.60
1958-59	1.239.0	15.25	32.11	43.80
1959-60	1,368.0	15.09	32.54	43.63
1960-61	1,588.0	15.70	34.81	45.62
1961-62	1,814.0	16.90	37.51	48.32
1962-63	2,089.0	16.27	36.66	47.87
1963-64	2,683.0	18.01	39.41	49.24
1964-65	3,189.0	19.50	41.67	50.53
1965-66	3,678.0	19.88	43.68	51.40
1966-67	4,427.0	20.74	47.23	53.18
1967-68	5,181.8	22.30	47.40	53.27
1968-69	5,807.6	21.76	46.86	52.74
1969-70	6,679.6	21.88	49.28	54.23
1970-71	7,662.1	22.74	50.15	54.84
1971-72	8,393.8	20.77	31.83	58.35
1972-73	9,765.0	19.88	32.68	58.40
1973-74	11,428.2	20.59	32.96	58.38
1974-75	15,504.0	24.11	37.73	62.21
1975-76	19,437.0	24.49	37.78	63.85
1976-77	22,703.9	25.13	39.74	64.00
1977-78	24,142.9	24.32	39.22	63.55
1978-79	27,733.1	23.82	40.06	64.11
1979-80	32,110.9	23.56	35.38	63.78
1980-81RE[a]	37,945.1	24.27	37.16	62.23
1981-82BE[b]	42,269.6	25.33	37.42	65.19

Note: Revenue from sales tax includes the revenue yield from sales tax under the State Sales Tax Acts and under the Central Sales Tax Act, 1956.

a. Revised estimate.
b. Budget estimate. "Budget estimates" are for the forthcoming financial year and "revised estimates" are for the completed previous financial year.

Source: Reserve Bank of India Bulletins.

1. P.J. Thomas, *Growth of Federal Finance in India* (Oxford University Press, London, 1939).
2. Quoted by A.K. Chanda, *Federalism in India* (George Allen and Unwin, London, 1965), p. 250.

Table 2
Revenue from central sales tax
(million rupees)

States	1970-71	1975-76	1980-81 (RE)
1. Andhra Pradesh	36.2	243.9	255.1
2. Assam	6.0	69.9	31.6
3. Bihar	99.8	142.0	502.9
4. Gujarat	129.0	335.3	767.3
5. Haryana	—	182.2	427.9
6. Himachal Pradesh	0.2	2.0	8.4
7. Jammu & Kashmir	—	61.6	—
8. Karnataka	59.1	948.2	411.6
9. Kerala	35.7	81.8	200.0
10. Madhya Pradesh	106.4	274.3	441.2
11. Maharastra	374.3	859.8	1868.6
12. Manipur	—	—	—
13. Meghalaya	—	0.7	1.2
14. Nagaland	—	0.1	0.4
15. Orissa	63.5	79.1	198.8
16. Punjab	88.2	170.0	307.5
17. Rajastan	33.3	108.8	218.0
18. Sikkim	—	—	—
19. Tamil Nadu	137.9	332.7	720.0
20. Tripura	—	—	—
21. Uttar Pradesh	50.1	165.8	321.3
22. West Bengal	252.5	468.1	1016.0

Note: Revenue from central sales tax refers only to the yield under the Central Sales Tax Act of 1956.
Source: *Reserve Bank of India Bulletins.*

states but created the problem of vertical as well as horizontal tax overlappings with the consequent tax cascading effect on prices and the resultant distortions in distribution of income and resource allocation. The Australian judicial interpretation disregarded the financial autonomy of the states and created vertical federal imbalance. But it prevented vertical as well as horizontal federal tax overlappings and their ultimate adverse economic effects.

Anyhow, when it was finally resolved in favour of the states, some state governments started levying sales tax on the sale of all commodities at high rates. This became a matter of serious concern to the Central Government which was responsible for a policy of a stabilisation when such high rates of sales tax pushed up the prices. So, with a view to combatting the price impact of sales tax on essential commodities, the Central Government passed the Essential Goods Act (Declaration and Regulation of Tax on Sale or Purchase) in 1952, barring all states from levying further taxes on the sale of essential goods and from revising upward already operating tax rates. But by that time some states, e.g. Madras (now Tamil Nadu), had already reached the maximum rates and coverage points. As the Essential Goods Act had no retrospective effect, the Central Government could not control the effect of a high multiple point sales tax on the prices of necessaries. Rising prices increased the cost of living and led to upward revision of factor prices. This inflationary rise in prices adversely affected development activities during the Second Five Year Plan. Therefore the Planning Commission advised the Central and state governments to come to an agreement and suggested that the power to levy tax on certain commodities be rented out to the Central Government in exchange for the Central Government's guarantee to make good the loss of revenue due to such transfer. This is the background to the presently operating additional Union excise duties in the Indian federation (see Section IV for further details).

III. TAX ON INTER-STATE SALES

Article 286 of the Indian Constitution, as it stood prior to the Sixth Amendment Act to the Constitution of 1956, prohibited state legislatures from imposing a tax on the sale or purchase of goods outside the state or sales which took place in the course of import of goods into or export of goods out of the territory of India. For the purpose of determining an outside sale, Article 286(1), as it then stood, contained an explanation which defined an inside sale as one directly resulting in delivery of the goods for the purpose of consumption in a state, even in cases where the title to goods might have passed into other states. Article 286(1) also prevented states from imposing a tax on the sale or purchase of goods taking place in the course of inter-state trade or commerce subject to Parliamentary legislation to the contrary. In view of this, the states extended their jurisdiction to tax non-resident dealers and subject them to the sales tax law of the importing states which meant registration, filing tax returns, submission of accounts, payments of tax, etc., in the importing state.

Territoriality

The Supreme Court reviewed the position in the case of *Bengal Immunity Company Ltd.* and ruled that sales covered by the explanation to Article 286(1) would be subject to a ban imposed by Article 286(2). In other words, without a Parliamentary law it was held that the states' power to levy a tax on inter-state trade could not extend to non-resident dealers. Article 286 of the Constitution was intended to meet the problem of multiple taxation by states on inter-state trade and commerce, but legal difficulties under this Article manifested themselves very clearly with the Supreme Court decision in the case of the *State of Bombay v. United Motors* which permitted the consuming state to levy tax even on inter-state transactions. This judgement was overruled in the case of *Bengal Immunity Company v. State of Bihar*, according to which barring the states from taxing inter-state sales or transactions would aggravate the financial difficulties of the states. In the first judgement the Supreme Court sympathised with the administrative problems involved in the taxation of non-resident dealers, but in the second judgement the financial position of the state was considered to be at a disadvantage as it encouraged unnecessary movement of goods from one state to another in order to escape taxation through the device of an inter-state sale or transaction. Therefore remedial measures were called for and the Sixth Amendment Act to the Constitution was contemplated.

The Taxation Enquiry Commission (1953-54) went into the matter and on the basis of the Commission's recommendations the Constitution was amended by the Sixth Amendment Act of 1956 and the Central Sales Tax (CST) Act was enacted in 1956 by Parliament. The Sixth Amendment to the Constitution gave the following powers to the Parliament:

(1) to impose tax on the sale or purchase of goods where such sale or purchase takes place in the course of inter-state trade or commerce (Entry 82-A of List I (Union List) of 7th Schedule);
(2) to formulate principles for determining when a sale or purchase takes place outside the state or in the course of import of goods into or export of goods out of the territory of India (Article 286, clause 2);
(3) to put such restrictions and conditions in regard to the system of levy, rates and other incidence of taxes, as Parliament may by law specify, on state tax laws with regard to goods declared by Parliament to be of such importance in inter-state trade or commerce (Article 286, clause 3);
(4) at the same time Entry 84 of List II (State List) was made subject to the provisions of the new Entry 92-A of List I (Union List). Prior to this amendment, the explanation to Article 286(1) had defined a sale outside the state and this definition had resulted in considerable legal uncertainty.

The Sixth Amendment Act now gave Parliament the power to define a sale outside the state, thereby enabling easy amendment of the definition without the need for frequent constitutional amendments in case of difficulty. The new Article 286(3) did away with Parliament's power to restrict state taxation of commodities declared by Parliament to be essential for the life of the community. Instead, Parliament was now empowered to restrict taxation of goods declared to be of special importance in inter-state trade or commerce. The last clause, by providing Parliamentary control over inter-state sale of those commodities which are of special importance in inter-state trade, has put clause 3 of Article 286 on a more workable footing. Under this amendment, Parliament had defined the concept of inter-state sale and out-of-state sale, fixed the upper limits of sales tax rates and allowed the importing states to fix the exact rate of sales tax along with the power to exempt. Therefore, even now conditions exist where inter-state discriminatory tax is possible. Further, the attempt of the National Development Council to have a uniform tax on as many commodities as possible by extending additional Union excise duties, in place of state sales taxes, shows that no solution of the problem on a permanent footing has been devised in the country. One opinion in this connection is that,

> Equally good or even better results would perhaps have emerged as a result of series of decisions by the Supreme Court in actual controversies as is being done, for example, in the United States.[3]

3. A.T. Markose, "The First Fifteen Years of the Indian Constitution", in S.P. Aiyar and R. Srinivasan, *Studies in Indian Democracy* (1965).

The Sixth Amendment Act of 1956 laid the basis for the passing of the CTS Act of 1956. In the Preamble to the CST Act three objectives are stated:

(1) to formulate principles for determining when a sale or purchase of goods takes place in the course of inter-state trade or in the course of import into or export from India;
(2) to provide for the levy, collection and distribution of taxes on sales of goods in the course of inter-state trade or commerce; and
(3) to declare certain goods of special importance in inter-state trade or commerce and to specify the restrictions and conditions to which state laws imposing taxes on the sale and purchase of goods of special importance shall be subject.

The CST Act also helped to eliminate complete evasion of sales tax by means of out of state purchase, to provide for a degree of uniformity on the maximum rate of sales taxation on certain raw materials of considerable importance in the entire country and to provide some sales tax revenue to exporting states.

The Taxation Enquiry Commission (1953-54), whose recommendations formed the basis for enactment of the CST Act of 1956, had suggested that the tax on inter-state sales of goods should be levied at the rate of 1% by the dispatching state. The CST applied only to inter-state sales made by registered dealers, as such dealers were assessed to local sales tax again when the goods were resold by them after importation from other states. Inter-state sales to unregistered dealers or consumers were not assessed to local sales tax again on goods imported by them from other states. The rate of CST was raised from 1 to 2% from 1 April 1963, from 2 to 3% from 1 July 1966, and from 3 to 4% from 1 July 1975. This was done mainly as a measure of additional resource mobilisation for the states. When the tax rate was raised from 3 to 4%, the matter was examined in consultation with the state government and also discussed in the meetings of the Regional Councils. While most of the states, particularly the manufacturing states, were in favour of raising the rate of tax to 4%, the states which depend mainly on goods imported from other states opposed the proposal. These states maintained that the increase in the rate of CST could accelerate the tendency to avoid tax through consignment transfers. Further, they maintained that the incidence of CST largely falls on the consumers in the importing states and therefore any increase in the rate of CST would inhibit the capacity of the importing states to raise resources. And finally, an increase in the rate of tax was likely to have an adverse effect on the prices of goods. However, on the persistent demand from many states to increase the rate of CST, it was raised to 4% from 1 July 1975.

The Indirect Taxation Enquiry Committee which examined this aspect in 1976 observed that the main object of fixing the CST at the low level of 1% in 1956 was to ensure that while some revenue would accrue to the producing states, it would not result in raising unduly the burden on the residents of the importing states. The low rate of CST would serve to plug loopholes that would arise if the goods sold across state borders were totally free of taxation. However, the Committee observed that CST had become an instrument of transferring resources from the less developed to the more developed states.

Evasion of inter-state sales tax

It may be observed here that in order to avoid paying inter-state sales tax, manufacturers consign their products to their own depots located in other states so that no sales attracting CST take place. This places small producers at a disadvantage since they do not have the means to set up their own depots in different states.

For these considerations, the Committee felt that it was a mistake to look upon CST primarily as a source of revenue and to go on raising the tax on inter-state sales. The Committee therefore recommended reduction of the rate of inter-state sales tax to the original level of 1%. The Committee was of the opinion that lowering the rate of inter-state sales tax would itself generate economic pressures in favour of a rationalisation in the trend for high taxation of inputs, for if the sales tax rate on inputs is higher than the inter-state sales tax, manufacturers begin to import inputs from other states and thus pay a lower rate of tax.

As regards the loss of revenue as a result of such reduction in the rate of CST, the Committee was of the view that this could be offset in two ways. Firstly, if the tax rate were lower, dealers might not find it worthwhile to resort to subterfuge consignment transfers. Secondly, while revenue derived by a state on inter-state sales might go down, its capacity to have a higher sales tax on products originating outside its boundaries would go up. Though the loss and gain for such a state might not be quite balanced, there would be a more equitable distribution of sales tax revenue among the different states.

Section 15 of the CST Act of 1956 puts the following restrictions on the power of the state governments to levy sales tax on inter-state sales: (1) the rate of tax cannot exceed 4%; (2) CST cannot be levied more than once inside a state; and (3) if the goods on which CST has been levied are subject to local sales tax within the state and are subsequently sold in inter-state commerce, the local sales tax levied is refundable to the inter-state seller and the tax on inter-state commerce alone is leviable. Further, there is no exemption limit for any dealer in the case of CST.

Raw materials

The CST Act of 1956 also introduced a provision concerning declared goods. The Taxation Enquiry Commission (1953-54), while recommending a free hand to the state legislatures in the matter of taxing inter-state sales, observed that the only exemption would be in respect of raw materials. The Commission recommended that such an inter-state sales tax, having an important inter-state bearing, makes it an appropriate item of control by the Central Government. The Commission, however, felt that such control over inter-state items of taxation should be very strictly confined to a very small number of well defined commodities of special significance in inter-state trade.

The criteria used for selecting such items were: (1) the item should be raw material or largely in the nature of raw material, (2) as a raw material or later as finished good based on such raw material, it should, in terms of volume of inter-state transactions, be of special importance in inter-state trade and commerce, and (3) in terms of the country as a whole, it should also be of special importance from the point of view of the consumer or of industry.

The provisions of Section 14 of the CST Act as it was originally enacted were very much confined to the above recommendations of the Taxation Enquiry Commission and only 6 items suggested by the Commission, namely, coal, iron and steel, cotton, hides and skins, oil seeds and jute, were named as declared goods. But gradually the list expanded. Cotton yarn was an important raw material going into the production of cloth and many other finished products and was thus added to the list in June 1957. In addition to the goods mentioned above, Section 14 of the CST Act declares sugar, tobacco and all its products, textiles including cotton fabrics, woollen fabrics, rayon and artificial silk fabrics as goods of special importance. These goods are covered under the additional Union excise duty provision. An amendment to the CST Act of 1956 which was enacted in 1976 added certain specified pulses and cereals to the list. Crude oil was also included. The rate of tax in respect of most of the declared goods is 4%, with a few exceptions such as oil seeds and cotton yarn which are taxable at the rate of 2%. In the case of taxable sugar and tobacco, different rates are fixed.

At the Conference of Chief Ministers held in New Delhi on 16 and 17 September 1980, the question as to whether the existing list of declared goods should be expanded was discussed. No decision was taken at that meeting. But in the meeting of Chief Ministers held on 15 February 1981, it was considered that *vanaspathi* (refined oil), life-saving drugs and kerosene might be included under additional excise duties. However, no final decision was taken and the Union Finance Minister stated that an Expert Committee would be appointed to examine the financial implications of such a transfer. Accordingly, the Central Government has appointed a Committee to examine the proposal and make recommendations.

Taxation of services

The existing constitutional power of the state governments to levy sales tax is confined to the sale of goods and does not mention the power to levy tax on the sale of services. This lacuna has been taken advantage of by the hotel industry and the works contract industry to evade sales tax. On the insistence of the state governments, the Janata Party accepted the recommendation of the Law Commission to amend the Constitution with a view to strengthening the hands of the state governments in regard to taxation of consignment transfers, work contracts and hotel services. There was large-scale evasion of sales tax by dealers through these methods and hence the state governments went on pressing for amendments to the Constitution to empower the state governments to tax these services. The Central Government referred the matter to the Law Commission which recommended that the Constitution be amended for the purpose. However, the Indirect Taxation Enquiry Committee suggested that the power to levy tax on those activities involving the sale of services should not be given to the state governments but should be retained by the Central Government under the CST Act. Accordingly, the Central Government has decided to amend the Constitution and incorporate the provisions into the CST Act of 1956 by amending it and fixing the rates of tax on these items and allowing the state governments to collect and appropriate revenue.

It may be observed that while the Central Government brings in the principles of "public importance", "essentiality" and "special importance" of the commodities to bar state governments from levying higher rates of sales tax, when it comes to the question of allowing the state governments to have the power to levy sales tax on other items which do not fall in that category, it does not want to delegate that power. Thus work contracts, consignment transfers and services may not be of such public or special importance to either the country or the government. Within services it may be possible to identify certain essential services to be exempted, but wholesale retention of these items under CST only begs the question whether the Central Government is really concerned about the national interest in persuading the state governments to allow it to extend additional Union excise duties or is simply interested in acquiring more and more fiscal powers. It is the onus of the Central Government to prove otherwise.

IV. ADDITIONAL UNION EXCISE DUTIES

The question of additional Union excise duties came up after the introduction of the Constitution. As I have already mentioned above, it emerged out of the failure on the part of the Government of India to control the powers of the state governments to levy sales tax on commodities of common consumption. Therefore the question of the Central Government acquiring, on a rental basis, the power to levy Union excise duty in place of state sales taxes on certain commodities of special importance was contemplated. As the Fourth Finance Commission rightly observed

> A scheme of Centrally levied additional duties of excise in replacement of states' sales tax combined with a distribution scheme is essentially in the nature of tax rental agreement. It can come into operation or be expanded in coverage only if the Union and states agree amongst themselves.[4]

Tax rental arrangement

The question of levying additional excise duties was brought before the Taxation Enquiry Commission (1953-54) which rejected the idea. Undaunted by this rebuff, the proposal was discussed in the National Development Council in its meeting in January 1956. The National Development Council recommended that the sales tax on textiles, sugar and tobacco be replaced by additional excise duties. This suggestion was not received with enthusiasm by the state governments. The National Development Council in its meeting of 8 December 1956 reiterated its ealier view. Later the Central Government persuaded the state governments to accept the proposal. In the interest of the stable development of the country's economy, the state governments reluctantly agreed to this arrangement. The state governments stopped levying tax on manufactured textiles – including cotton fabrics, rayon and artificial silk fabrics and woollen fabrics, sugar, and tobacco, including manufactured tobacco – and the Central Government started levying additional Union excise duties on these commodities from the financial year 1957-58. This is mainly in the form of a tax rental arrangement similar to that which is in operation in Canada and Australia. Thus the Central Government has been assuming the states' taxing powers directly through Constitutional amendments and indirectly under the pretext of exigencies of planning. The Sixth Amendment to the Constitution and the subsequent CST Act of 1956 were an inroad into the taxing powers of the state governments which had originally been allocated by the framers of the Constitution. This tax rental arrangement is another inroad by the back door which has opened the gates wide for the Central Government ultimately to replace the entire sales tax with Union excise duties through a gradual process. This is evident from the way in which the additional Union excise duties agreement has been implemented.

Control of prices

To what extent the Central Government has been able to control prices through this tax rental arrangement is a question which has not yet been answered by the Central Government. When this arrangement was put into operation the Second Finance Commission, which was just then set up, was asked to recommended to Parliament principles for distribution among the states of the proceeds from these rented taxes. The Commission examined the issue critically and recommended to the Central Government that it guarantee the loss of revenue yield from the sales tax on these commodities in 1956-57 at the rates then prevailing in the respective states. The Commission recommended that the balance, if any, after distributing the guaranteed amount be distributed on a proportional basis: each state's population as a fraction of the total population of all states. Thus the first basis is the compensation principle in order to cover the revenue gap resulting from the partial transfer of this source of revenue, and the second basis is population or the need of the states.

4. Government of India, *Report of the Finance Commission* (New Delhi, 1965), p. 31.

The success of this scheme encouraged trade and industry to press for an extension of the scheme to other commodities. In response to this demand the Central Government set up a Committee of Chief Ministers and Finance Ministers of all the states in September 1959 under the Chairmanship of B.C. Roy, then Chief Minister of West Bengal. The Committee submitted its report in October 1960 in which it recommended the levy of additional excise duties on mill-made silk fabrics only. The Committee also examined thoroughly the question of extending the scheme to cover matches, paper and vegetable products and came to the conclusion that the scheme need not be extended to any more commodities. Following the recommendation of the Committee and with the consent of the states, the Central Government imposed an additional excise duty on mill-made silk fabrics in lieu of sales tax with effect from 1 March 1961. By the time the Third Finance Commission was appointed and asked to make recommendations on the distribution of the yield from additional Union excise duties, many states had realised that the amount of compensation revenue they received on the recommendations of the Second Finance Commission was far less than what they could have raised by increasing the rates of sales tax on the increasing sale of the commodities. Therefore,

> the states urged that the guaranteed amount should be revised to take into account the increases in rates of tax effected by them after the amounts guaranteed had been determined. They also complained that as a result of the surrender of the sales tax, they lost over a period of years and that they should be insulated against further future losses.[5]

But the Third Finance Commission maintained that,

> the Second Commission had rejected the suggestion that not only the revenues currently derived but prospective revenues should also be taken into account in determining the guaranteed amounts. So must we also dismiss the suggestion that we should make an estimate of possible losses sustained and refix the amounts guaranteed. For one thing, such an examination would be outside the terms of our reference; and, for another, such a determination would be impracticable on statistical material now available.[6]

Therefore the Commission recommended the distribution of the net yield from additional Union excise duties on the same basis as was recommended by the Second Finance Commission, except that it recommended that the balance after distributing the guaranteed amount be distributed partly on the basis of population and partly on the basis of a percentage increase in the collection of sales tax in each state since 1957-58. There was no indication as to the relative weight to be given to these criteria, which implies that the Commission left room for the discretion of the Central Government in distributing this part of the yield from rented tax.

The Fourth Finance Commission did not bother much about this issue and though the states repeated their old grievances the Commission recommended continuation of the old method of distributing the guaranteed amount. The Commission also recommended that the balance of the net proceeds after distributing the guaranteed amount be distributed entirely on the basis of the proportion of sales tax revenue realised in each state to the total sales tax collected in all the states taken together. One of the members of the Fourth Finance Commission questioned this change, over the method suggested by earlier Commissions, on the grounds that, "reasons of certainty and stability hold good in the present case too, if anything more clearly than in the distribution of the income tax proceeds".[7]

Dissatisfaction with tax rental arrangement

By the time the Fifth Finance Commission was appointed the dissatisfaction of the states with this tax rental arrangement had reached its saturation point. This was for certain legitimate reasons:

(1) The states received compensatory grants only to the extent of their collection of revenue from sales tax on these commodities in 1956-57, and even though the actual yield from additional Union excise duties exceeded their total guaranteed amount, the Finance Commissions recommended that this excess balance be distributed partly on a population (or general need) basis and partly on the relative growth of sales tax yield in different states. This mode of distributing the balance, they felt, was unjustified in view of their constitutional right to have the entire yield on the basis of the compensation or derivation principle. The Finance Commissions could not do justice because of their inability to work out the derivation basis and share of each state in the net proceeds.

(2) Even the guaranteed amount was based on the rates of sales tax prevailing in 1956-57 which they considered as unjust because of the lower rates prevailing then in some states. Further, the Central Government increased its own basic excise duty rates on similar commodities but kept the rates of additional Union excise duties constant on the grounds of preventing tax-induced cost push inflation. This policy was unjust and obviously backed by illogical reasons. Furthermore, in 1957-58 only cotton textiles could be considered to be necessaries whose prices might have worried the Central Government. The very emergence of this tax rental arrangement was a result of the failure of the Essential Goods Act to control the prices of necessaries. But the Central Government was trying to restrict the states from taxing such commodities heavily while itself was increasing the rates of Union excise duties every year from 1957-58 on necessaries like kerosene, tea, etc. It is a paradox to find that while the Central Government has gone on adding its basic excise duties to the general prices of the necessaries without any concern for either the stability of prices or the regressive distribution effects, at the same time it has kept constant the rates on artificial silk fabrics, woollen fabrics, sugar and tobacco, which are by no means necessaries in India. I would like to know the criteria or principles and considerations which guided the Central Government to select only these commodities as essential

5. Government of India, *Report of the Finance Commission* (New Delhi, 1961), p. 26.
6. Ibid.
7. "Minute of dissent by Mohanlal Gautam", *Report of the Finance Commission* (New Delhi, 1965), p. 82.

goods for the tax rental arrangement while at the same time leaving in the hands of the states such goods as kerosene, tea, gur, etc., which are basic necessities in urban areas. I would stretch my imagination a bit and ask: was it because the state governments did not agree to their inclusion? Or was it because of the corruptive pressure of the manufacturers of textiles, sugar and tobacco on the bureaucracy of the Finance Ministry and/or the Central Government? The first possibility seems to be remote as the states agreed, although reluctantly, to the present arrangement without prolonged negotiations and discussions. Therefore the second possibility is more probable. This has been borne out by the fact that the Federation of Indian Chambers of Commerce and Industry has consistently pressed the Central Government and the Finance Commission to continue the present arrangement and even to extend it to other manufactured commodities.

(3) The state governments increased their rates of sales tax on other comparable commodities from 1957-58, whereas the rates of those commodities which fall under the rental arrangement remained constant and the Finance Commissions refused even to enhance the guaranteed amount to the extent of actual net proceeds from additional Union excise duties having regard to the growth of sales tax revenue of the states and the growth of consumption. This gross disregard for their legitimate request angered the states and some of them started pressing for the termination of the whole tax rental arrangement. This was understandable because they had surrendered this tax power in a simple meeting of the National Development Council, placing the national interest above their own and in good faith believed that their financial position would not be weakened. As Mr. K. Santhanam has observed:

> Under normal federal political conditions, there would have been discussions in every legislature and in the Press as to whether the states sould surrender or not. . . . The decision to surrender the tax and substitute them by additional excise duties was taken at a single sitting at which many Chief Ministers had not even fully consulted their own Cabinets.[8]

But after experiencing the financial consequences of the arrangement,

> Most of the states have regretted this hasty decision and represented before the Third Finance Commission that by this surrender they had been deprived of an expansible and growing source of revenue and the Commission should take into account the losses in the devolution of resources they recommend.[9]

The Fifth Finance Commission, however, was more sympathetic to the views of the states. The Commission found that between 1957-58 and 1967-68, the revenue from basic and special Union excise duties on the commodities covered by the tax rental agreement increased by more than 70% whereas the revenue from additional Union excise duties on these commodities increased by only 45%. The Commission also found that the rates of sales tax levied by some states on comparable commodities were generally higher than those of the additional Union excise duties. From these two premises the Commission inferred that if states were free to levy sales tax on the commodities covered by the rental agreement, many of them would have been realising more revenue from them than they had received as compensatory payments. The Commission agreed with the rationale and advantages of the tax rental scheme, but in view of the opposition of the states to it, the Commission opined that it would not be desirable to continue the scheme unless the Central Government, in consultation with the state governments, could arrive at a more satisfactory agreement with suitable modifications to the existing scheme. In view of this suggestion the Commission did not make any recommendations in regard to extending the existing agreement to cover other commodities.

For the same reason it was also not in favor of reopening the question of determining the guaranteed emount, though owing to readjustments to Chandigarh as a Union Territory, the states' total guaranteed amount declined from 325.4 million rupees to 324 million rupees. Therefore, the Commission recommended that the guaranteed amount be distributed on the basis of the old criterion and the balance be distributed for 50% of its amount on the basis of sales tax collections, excluding inter-state sales tax, during 1965-66 to 1967-68 (in direct proportion to the ratio of collections in each state to the total collection in all states), and for 50% of its amount on the basis of population. The actual shares of different states under the recommendations of the past Finance Commissions may be seen in Table 3. The Fifth Finance Commission, like all the earlier Commissions, felt that the consumption of these commodities in different states was theoretically the best basis for distributing the balance, but in the absence of reliable data, "collection" and "population" were considered the next best criteria. The Commission recommended that while these arrangements continue the rates of duties be made ad valorem as far as possible and be revised periodically to secure a reasonable degree of co-incidence with prevailing prices and the general level of sales taxes on similar items levied by the states.

Some states wish termination of tax rental arrangement

The recommendations of the Fifth Finance Commission to review the entire tax rental arrangement encouraged some states to come out openly for termination of the arrangement. Andhra Pradesh and Tamil Nadu for instance, submitted opinions to the Central Government to this effect. Alarmed by these demands, the Central Government referred the issue to the National Development Council, as the original agreement was reached in one of its meetings. The National Development Council appointed a Committee to examine the issue and recommend a future course of action. The Committee recommended continuation of the scheme but suggested an increase in the incidence of duties by 10.8% within a period of two to three years. These recommendations have been reluctantly accepted by the states.

Thus, even the Committee of NDC failed to get to the root of the problem, namely, the principles for distribut-

8. *Union-State Relations in India* (Asia Publishing House, Bombay, 1969), p. 47.
9. A.K. Chanda, Op. cit., p. 280.

Table 3
States' share in the yield from additional Union excise duties as recommended by the Second, Third, Fourth and Fifth Finance Commissions

	Second Finance Commission		*Third Finance Commission*		*Fourth Finance Commission*		*Fifth Finance Commission*	
	Guaranteed amount (Rs. m)	*Share in the balance %*	*Guaranteed amount (Rs. m)*	*Share in the balance %*	*Guaranteed amount (Rs. m)*	*Share in the balance %*	*Guaranteed amount (Rs. M)*	*Share in the balance %*
Andhra Pradesh	23.50	7.81	23.53	7.75	23.53	7.42	23.53	8.13
Assam	8.50	2.73	8.51	2.50	8.51	1.98	8.51	2.47
Bihar	13.00	10.04	13.02	10.00	13.02	6.17	13.02	8.40
Gujarat	*	*	32.35	5.40	32.35	7.43	32.35	6.35
Haryana	**	**	**	**	**	**	6.55	1.70
Kerala	9.50	3.15	9.51	4.25	9.51	5.65	9.51	4.84
Madhya Pradesh	1.50	7.16	15.52	7.00	15.52	4.62	15.52	6.34
Maharastra	96.00	17.52	63.78	10.60	63.78	19.87	63.78	13.89
Mysore	10.00	5.13	10.01	5.25	10.01	5.21	10.01	6.00
Orissa	8.50	3.20	8.51	4.50	8.51	2.58	8.51	3.13
Punjab	17.50	5.71	17.52	5.25	17.52	5.01	9.61	2.98
Rajastan	9.00	4.32	9.01	4.00	9.01	3.17	9.01	4.42
Tamil Nadu	28.50	7.74	28.54	9.00	28.54	11.13	28.54	9.63
Uttar Pradesh	57.50	17.18	57.58	15.80	57.58	7.83	57.58	12.99
West Bengal	28.00	8.31	28.04	9.00	28.04	11.93	28.04	8.75
Total	325.00	100.00	325.40	100.00	325.40	100.00	324.04	100.00

Notes: * Included under Maharastra.
** Included under Punjab.
Source: Reserve Bank of India Bulletin, September 1969, p. 1441.

ing the yield from additional Union excise duties. By increasing the incidence or overall rates by 10.8%, it has provided only an ad hoc and partial solution. It is ad hoc because the increased guaranteed amount is related neither to the average increase in the sales tax rates of the states on similar commodities to the rented commodities or the increase in the rates of basic union excise duties on comparable commodities nor to the growth of revenue from sales tax or from the basic Union excise duties on comparable commodities. It is partial because it has left unmodified the other part of the problem, namely, distribution of the net proceeds from the additional Union excise duties among the states.

State Finance Ministers reject further extension of additional excise duties

In February 1963, the state Finance Ministers examined this tax rental scheme again and were not in favour of replacing sales tax with additional excise duties on more commodities. They reiterated the same views at another Conference in November 1963. The National Development Council at its meeting of 28 December 1970 considered the Fifth Finance Commission's observations and agreed to continue the present arrangement subject to:

(1) the specific duties being converted into ad valorem duties except in regard to unmanufactured tobacco,
(2) the incidence of additional excise duties as a percentage value of clearance to be raised to 10.8% in a period of two to three years,
(3) that a ratio of 2:1 between the yields of the basic and special duties on the one hand and the additional excise duties on the other should be achieved and maintained, and
(4) a Standing Review Committee consisting of representatives of the Central and state governments should be set up to provide an opportunity to review the working of the scheme.

The Sixth Finance Commission, after examining this arrangement, found that there is no need to distribute first a guaranteed amount and then the balance, as at present all the states will get more than their former guaranteed amounts in view of a substantial increase in the net yield from the additional Union excise duties, but that the entire net yield should be distributed among the states, 70% in proportion to the population of each state as a fraction of the total population of the country, 20% in proportion to the income of each state as a fraction of the total income of all the states, and 10% in proportion to the production of each of the commodities taxed which originates in the respective states. The percentage share of each state has been indicated by the Commission as shown in Table 4. Although these changes in the basis of distributing the net yield from these duties under the

Table 4
States' share in the yield from additional Union excise duties
(Percentage share in the total net yield)

States	Sixth Finance Commision's Recommendation	Seventh Finance Commission's Recommendations		
		Sugar	Textiles	Tobacco
Andhra Pradesh	8.39	5.245	8.018	8.018
Assam	2.47	2.408	2.297	2.297
Bihar	9.36	5.933	7.219	7.219
Gujarat	5.91	8.742	6.013	6.013
Haryana	1.94	2.666	2.789	2.789
Himachal Pradesh	0.59	0.860	0.734	0.734
Jammu & Kashmir	0.73	0.831	0.744	0.744
Karnataka	5.62	4.901	6.081	6.081
Kerala	3.58	3.783	4.019	4.019
Madhya Pradesh	6.98	6.019	6.419	6.419
Maharastra	11.65	17.082	13.506	13.506
Manipur	0.17	0.143	0.185	0.185
Meghalaya	0.17	0.029	0.171	0.171
Nagaland	0.08	0.115	0.084	0.084
Orissa	3.59	2.178	3.456	3.456
Punjab	2.68	6.220	4.268	4.268
Rajastan	4.17	4.729	4.365	4.365
Sikkim	—	0.057	0.034	0.034
Tamil Nadu	7.27	6.449	7.707	7.707
Tripura	0.25	0.172	0.256	0.256
Uttar Pradesh	16.10	13.184	12.544	12.544
West Bengal	8.30	8.254	9.091	9.091

Sources: (a) *Report of the Sixth Finance Commission* (Government of India, New Delhi, 1973), p. 21.
(b) *Report of the Seventh Finance Commission* (Government of India, New Delhi, 1979), pp. 48-50.

rental arrangement might give more revenue to the states which rank higher in population and in the production of these commodities, they are not as appropriate as the derivation principle of distributing the net yield from these duties in the long run.

The Seventh Finance Commission, however, while taking note of the complaints from most of the states on the manner in which the Central Government has implemented the scheme of additional excise duties, observed that:

> We cannot but take note of the tardy progress made by the Government of India in implementing the arrangement reached between them and the State Governments in 1970. . . . We trust that the Government of India would take urgent steps to implement the agreement fully as it is basic to the scheme for the replacement of sales tax by additional excise duties. In the alternative, if the prevailing state of economy makes it impracticable to abide by these conditions then it is only fair that the terms of the agreement should be renegotiated. . . . No meeting of the Review Committee has been convened. So far, though it was intended that it would meet at least once in a year. . . . We urge that the regular meetings of the Review Committee should be held.[10]

The Seventh Finance Commission recommended that the same criteria as suggested by the Sixth Finance Commission be followed for distributing the states' share in the net yield from additional Union excise duties.

It should be mentioned here that to fulfil the objectives set by the National Development Council, the Central Government attempted to ensure that, though reductions in duty were effected, the yield from additional excise duty did not suffer. In the recent past, whenever the Central Government has had to adjust the excise duty on sugar, it has sought to ensure that the rates of additional excise duties remained untouched. It should also be noted that in the budget of 1975-76, although art silk fabrics were exempted from basic duty, they continued to remain subject to additional duty. The decision of the National Development Council in 1970 contemplated the maintenance of a 2:1 ratio between yields from the basic (including special) excise duties on the one hand and additional excise duties on the other hand. As a result of the Central Government's attempts, the ratio between the basic excise duties and additional excise duties on these commodities has improved from 3.74:1 in 1971-72 to 2.31:1 in 1980-81. The National Development Council in 1970 also visualised that the incidence of additional excise duties as a percentage of the value of clearance was to be raised to 10.8% over a period of two to three years. This implied that the yield from basic and special excise duties should be 21.6% of the value of clearances of these commodities. The total incidence would then work out to be 32.4% of the value of clearance. The Review Committee has since been set up under the chairmanship of the Secretary, Planning Commission, with representatives of the Central and State Governments. Thus the Central Government was pushed into a defensive position as a result of the opinions expressed by the Finance Commissions. However, this was changed by the recommendations of the Indirect Taxation Enquiry Committee in 1977.

Indirect Taxation Enquiry Committee

The Indirect Taxation Enquiry Committee, which submitted its report in 1977, suggested that some measure of uniform sales tax was called for as rate differentials encourage uneconomic diversion of trade in a manner which results in a loss of revenue to the state with a higher rate of taxation. Further, the objective of making many products available at uniform all-India prices is thwarted because of the varying incidence of sales tax from state to state.

The committee pointed out that the operation of states' sales tax in India has given rise to the following distortions:

(1) legal and administrative and procedural complexities which afflict trade and industry,
(2) unhealthy trends generated by the existence of different rates of sales tax on the same commodity in different states,
(3) ways in which the sales tax imposed by one state effect other states, and
(4) the problem of cascading and distortions in factor prices.

10. Government of India, *Report of the Finance Commission* (New Delhi, 1979), pp. 65-66.

The Committee no doubt recognised the role of sales tax in widening the commodity tax base in the country by covering the primary agricultural products which are left out by Union excise duties. The Committee also observed that from the point of view of the states:

> under our federal constitution, the states must have adequate powers of taxation of their own. The question is not merely safeguarding their revenues by providing for adequate devolutions from the Centre. The measure of autonomy and responsibility to their own electorate which our Constitution envisages for state governments can only be sustained if they have adequate and independent powers of taxation. It is also urged on behalf of this point of view that autonomy should also include the discretion on the part of the people of different states, to have a smaller or larger public sector according to their respective choices.[11]

After mentioning these points of view of the states, the Committee came to the following conclusion:

> On the other hand the arguments put forward by state governments to which we have referred above weighty as they are, do not necessarily lead to the conclusion that state governments must be left with all the powers that they have at present in the matter of sales. . . . An abridgement or some limitation of the powers of state governments to levy sales tax cannot be ruled out of consideration on the ground that the states must have their own autonomous powers to tax because the total revenue from sales tax need not be necessarily reduced.[12]

Further, the Committee endorsed the view put forward by trade and industry to merge sales tax with Union excise duties or, alternatively, to extend the coverage of additional Union excise duties to other commodities on which sales tax is levied. This suggestion, as I have already pointed out, has been consistently opposed by the state governments in the past.

New offensive to force the states to surrender taxing power

The Central Government took the Indirect Taxation Enquiry Committee's recommendations seriously and placed before the National Development Council meeting a proposal to extend the additional Union excise duties to other commodities. Thus a new offensive is underway to force the state governments to surrender their power to levy sales tax to the arbitration of the National Development Council. According to the memorandum prepared by the Union Ministry of Finance for the consideration of the National Development Council, because of the diversity of sales tax rates on petroleum products, despite uniform ex-refinery prices, running costs of transport are adversely affected causing diversion of trade. In respect of products like cement, drugs and petroleum products, it will be desirable, according to the Committee, to have the scheme of additional excise duty extended to them, more so because statutory price control is effective to cement and medicines. In the case of petroleum products, their basic ceiling selling prices are fixed by the Pricing Committee. These items are also manufactured in the organised sector and the cost of collection of the levy from fewer assessees as against the sales tax from a large number of dealers would be itself a point in favour of replacing sales tax with additional excise duty. Over and above this, the social consideration of making available these products at uniform prices would be well served by imposing the additional excise duty in lieu of sales tax. On these considerations, the memorandum pleaded that the proposal prima facie is worth considering.

Enlargement of the scheme of additional excise duties to the essential items mentioned above was discussed at a meeting of Chief Ministers held on 19 and 20 May 1979. While the proposal was supported by states like Himachal Pradesh, Andhra Pradesh and Jammu and Kashmir, other states objected on the grounds that

(1) the Central Government has not implemented the 1970 agreement to raise additional excise duty to 10.8% of clearance value,
(2) whereas sales tax revenue has increased 78 times from 1958-59 to 1978-79, the additional excise duty has increased 17 times, and
(3) additional excise duty is levied at the manufacturing stage whereas sales tax is levied at the retail stage. On the question of uniformity, some states felt that if it is desired, it would be brought about by discussion amongst the states.

After the Congress (I) government came into power, this proposal was again taken up at the National Development Council meeting in 1980. The Union Finance Minister convened a meeting of Chief Ministers on 16 September 1980 and in his keynote address to the meeting he presented the following proposals for their consideration:

(a) Achievement of uniformity of sales tax rates among the states.
(b) Enlargement of the list of items of goods of essential nature, in particular essential raw materials on which the incidence of tax be kept to the minimum. The items that are suggested for inclusion are the inputs which are not used as final products, e.g. soda ash, sodium hydrosulphate, acids, basic resins (an adhesive material) and non-ferrous metals.
(c) Extension of additional Union excise duties in place of sales tax to items like vanaspati, petroleum products, cement, drugs[13] and pharmaceuticals.
(d) Identification of items of export importance for concessional treatment under sales tax by the states.
(e) Rationalisation of exemption limits and facilities for compounding sales tax.
(f) Abolition of octroi (a tax on goods entering municipal areas for sale).
(g) Constitutional amendments to enable the levying of sales tax on consigment transfers, leases of goods, supplies of foodstuffs in hotels.

These proposals were opposed by the Finance Minister of West Bengal and the Chief Ministers of Kerala, Tamil Nadu and Tripura. The proposal to extend additional Union excise duties to other commodities was then brought before the National Development Council. Even then, many state governments opposed it, so the National Development Council appointed a Committee of Chief Ministers headed by the Chief Minister of Kar-

11. Op.cit., p. 211.
12. Ibid.
13. This was first suggested by the Hathi Committee.

nataka to go into the matter and make recommendations. This Committee of Chief Ministers recommended the appointment of an expert committee to examine the financial implications of the proposal for different states. Accordingly, the Union Finance Minister appointed a Committee with a former Chief Minister as Chairman and an economist as a member to examine the entire proposal, with particular reference to the revenue implications to the state governments. As expected, the Committee is facing united opposition from the states for the extension of additional Union excise duties to drugs, kerosene and cement.

Although the Indirect Taxation Enquiry Committee took note of the views expressed by the states, it did not examine them in their wider context. The short-term consequence will be the financial loss to the state governments if the sales tax is replaced with additional Union excise duties. The extent of such loss varies from state to state. The worst sufferers will be Gujarat, Maharashtra, Tamil Nadu and West Bengal. Even the overall financial dislocation will be enormous for other states as is evident from Table 5.

The long-term implications will be quite far-reaching. In the Indian context although India is basically a federation, the Constitution makes it a unitary political system where the Central Government is supreme in both the financial and political spheres. Further, the operation of the Congress Party in the past, right from the top to the village panchayat level, in a monolithic way centralised the political power, administrative power and even the financial power under the pretext of planning and development. Although this trend was temporarily reversed during the Janata Party rule, it has come back again in full swing. It is always better to allow the states to retain financial autonomy so that they have a chance to function as autonomous units in a federation. If the Central Government attempts to merge the sales tax with Union excise duties or to extend the additional Union excise duties to several commodities covered by sales tax, the financial autonomy of the states will be reduced; and once such a transfer occurs there will be no occasion to reverse it even after realising the consequences of such a change. This has been borne out by the experience of the Australian federation. In Australia, the state governments still have concurrent powers to tax income. But this is only on paper. After surrendering those powers to the Commonwealth Government during the War, they have never regained them, purely for political reasons. The states' financial autonomy in India will remain only on paper if the state governments are made to implement national prohibition policy by abolishing state excise duties over and above losing their sales tax power. Therefore it is necessary for the state governments in India to learn the bitter lessons of history from other countries and to resist with all their might any encroachment of the Central Government on their taxing power. What is more, the existing arrangement in regard to additional excise duty is not even appropriate. The public has never been informed as to the basis for selecting several commodities to be brought within the scope of additional Union excise duties. For instance, tobacco cannot be considered a necessary item nor even an important raw material.

Table 5
Relative importance of sales tax revenue for the state governments in India 1980-81

State	Revenue from sales tax (Rs. m)	Revenue from sales tax as % of total revenue	Revenue from sales tax as % of total tax revenue
1. Andhra Pradesh	2729.3	22.31	31.90
2. Assam	307.7	10.18	18.60
3. Bihar	1785.8	18.71	25.57
4. Gujarat	3700.0	36.11	51.03
5. Haryana	1080.0	23.53	36.56
6. Himachal Pradesh	133.6	6.17	24.97
7. Jammu & Kashmir	141.0	5.11	22.30
8. Karnataka	2420.0	25.09	35.89
9. Kerala	1820.0	27.86	38.22
10. Madhya Pradesh	1871.7	16.50	28.42
11. Maharastra	7322.1	36.36	50.70
12. Manipur	20.0	3.45	17.51
13. Meghalaya	19.8	2.81	17.27
14. Nagaland	17.5	1.81	23.49
15. Orissa	712.2	12.23	25.46
16. Punjab	1600.0	28.39	37.55
17. Rajastan	1450.0	19.86	36.96
18. Sikkim	5.0	1.35	17.36
19. Tamil Nadu	4105.1	34.97	47.40
20. Tripura	14.0	1.38	10.06
21. Uttar Pradesh	3139.7	17.18	26.31
22. West Bengal	3550.6	30.20	39.61

Note: * Excluding withdrawal from Revenue Reserve Fund or 8 million rupees.

The foregoing arguments are intended to defend the continuation of sales tax in its substantive form in the hands of the state governments in order to safeguard their financial autonomy. However, I do not intend to suggest thereby that the present anarchy in indirect taxes should continue in the country. This aspect is discussed below.

V. DEFECTS IN THE EXISTING SALES TAX SYSTEM

Presently the sales tax structure in the Indian states consists of a single point sales tax on a large number of commodities and a multi-point sales tax on a few commodities (which cannot be covered effectively under a single point sales tax), central sales tax on the sale of commodities in the course of international or inter-state trade, on essential goods and also on certain declared goods. In recent years many state governments have gradually shifted over to a single point sales tax with a view to reducing the cascading effects of a multi-point sales tax on the final prices of the commodities. Unfortunately, wherever the state governments have shifted over to the single point sales tax, the tax is levied at the first point of sale immediately after manufacture or production of goods. This is intended to prevent any possible evasion which may occur if the sales tax is levied at the point of retail sale. From the point of view of plugging the loophole of such a single point sales tax, the imposition of a single point sales tax at the first point of sale may be justified.

The states impose sales tax at the point of production

Levying sales tax at the point of production is not consistent with the spirit of the Supreme Court judgement distinguishing Union excise duties from sales tax. Sales tax should be levied at a point after production, preferably nearer the point of consumption. The state governments' justification for levying the single point sales tax at the first point of the sale on the grounds that otherwise it would be evaded has some element of truth. But tax evasion cannot be prevented by changing the basis for levying alone. The state governments should strengthen their administration to plug administrative loopholes instead of keeping their administration out-moded. Further, when the sales tax is levied on a large number of commodities at the point of production the value added by the wholesaler and the retailer is kept outside the purview of the sales tax and as a result the tax base for sales tax goes on declining. Consequently, when the sales tax yield becomes inadequate the state governments will be tempted to raise the rates of tax to compensate for the loss of revenue resulting from a switch over to a single point sales tax from the multi-point sales tax. This will only bring the cascading effect of the multi-point sales tax back into operation through rate hikes. Secondly, the present form of the single point sales tax will only justify replacement of sales tax with additional Union excise duty as both of them are levied at the point of production. Therefore it is necessary for the state government to think of either levying a single point sales tax at the final point of the sale or introducing a double point sales tax, first at the point of wholesale and second at the point of retail to cover the value added through trade. Otherwise, if legal disputes arise, the courts may declare the single point sales tax to be Union excise duty and give a justification for ultimate replacement of sales tax with additional Union excise duties.

Multitude of indirect taxes

In some of the states where octroi has been abolished several additional levies have been introduced to compensate for the loss of revenue to the municipalities. In Karnataka, for instance, a surcharge on sales tax is levied if the level of turnover exceeds 0.15 million rupees. In addition, a turnover tax at a single point is levied on all dealers liable for sales tax. Over and above this, an entry tax has been levied on several commodities which could not be covered under the sales tax as they are under additional Union excise duties; in Karnataka and West Bengal this entry tax has also been extended gradually to other commodities. In other words, a multiplicity of taxes is being levied under the sales tax legislation in the states where octroi has been abolished, the most prominent among them being Maharashtra, Karnataka and West Bengal. In Karnataka, the Taxation Review Committee (1982) has recommended merging the surcharge with the basic sales tax, but has recommended extension of entry tax to other commodities and the continuation of turnover tax. Turnover tax is basically a multi-point sales tax. On the other hand, in order to satisfy the demand of converting the multi-point sales tax into a single point sales tax, the single point sales tax has been extended to several commodities. However, since the number of commodities under the multi-point sales tax goes on declining, the turnover tax has been introduced to take the place of the former multi-point sales tax. This is a backdoor manipulation of the "tax handle". The entry tax is no doubt intended to compensate for the loss of revenue as a result of the abolition of octroi and therefore may continue. But there is no justification for turnover tax. These taxes, if continued in operation, will create a much worse cascading effect on the prices of commodites.

Out-moded administration

Another defect of the sales tax in India is its out-moded administration. When the sales tax was first contemplated, a separate department of commercial taxes was created to administer the sales tax along with various other similar taxes, e.g. entertainment tax, etc. Today in a majority of states, sales tax is administered along with entertainment tax, betting tax, profession tax, luxury tax, central sales tax, etc. This has overburdened the department and as a result the sales tax, which is a major source of revenue for the states, has not received adequate attention. Consequently, various suggestions have been made to expand the existing commercial taxes department. This aspect has been thoroughly examined by the Karnataka Taxation Review Committee which recommended separation of the sales tax administration from all other commercial taxes. This has become necessary in almost all the states in order to pay more attention to the administrative procedures so as to reduce hardships to the dealers and improve vigilance to reduce evasion. It is also necessary to rationalise the tax structure periodically so as to minimise its adverse economic impact on the economy.

As I have already mentioned above, the Indirect Taxation Enquiry Committee found that there was a lack of uniformity in the turnover limits, a difference in fixing the period for assessment, such as calendar year or financial year, a limitation of the period for finalising the assessment, manner and limits for registration, specification of offences and punishment. The Committee suggested that the Central Government try to formulate uniform legislation on all these matters and circulate it among the state governments for its adoption. However, it would be meaningless to call sales tax source of revenue for the States if it is levied under one uniform Act all over the country. The sales tax has to be evolved by individual states according to their diverse circumstances. Therefore, while the suggestion to reduce the wide diversity is understandable, the idea of introducing blanket uniformity has no significance.

It appears as though the Committee has over-emphasised the need for uniformity in rates of sales tax, exemption limits and taxable turnover from the point of view of reducing diversion of trade and also hardship caused to the dealers. The Committee has overlooked the fact that in India where different states are at different levels of development, the fiscal powers of the state governments may be used to attract economic activity into the backward states. The uniformity argument goes against this objective of reducing regional imbalances through fiscal measures. It is true that for the purpose of encouraging economic activities in different states, it would be better to use subsidies rather than concessional tax rates. The different tax rates created a trade diversion effect even for the economically poor states, quite apart from creating other undesirable economic consequences. Sometimes the policy of using concessional tax rates for attracting economic activity may result in a "tax war" and defeat the very purpose. Therefore it is better to achieve "tax harmonisation"[14] and not uniformity among states in regard to tax rates, exemption limits and turnover limits, as far as sales tax is concerned, and to use subsidies for attracting and encouraging industrial activity to reduce regional imbalances.

Tax harmonisation

Keeping in view this need for tax harmonisation in the Indian federation, the Central Government encouraged the creation of Regional Councils for achieving such fiscal harmonisation. These Regional Councils have been created for the Southern, Eastern, Northern, Western, North-West and North-East regions. The Finance Ministers and the Finance Secretaries, including the senior officers of the sales tax administration, attend these meetings periodically and discuss the problems faced by adjoining states in regard to rates, exemptions and legal complexities. The meetings of Regional Councils are also attended by three officers of the Central Government, one from the Finance Ministry, one from the Ministry of Trade and Commerce and one from the Ministry of Law. However, while these regional councils have met frequently, their recommendations have not been implemented. These meetings should not end with a mere exchange of views but follow-up actions should also be initiated.

In recent years the Chief Ministers' Conference has also been organised periodically to sort out and to exchange views of mutual interest. The Chief Ministers' Conference of 16 and 17 September 1980 discussed the scope for rationalising state sales taxes. The discussion focussed on two aspects, namely, achieving uniformity in the rates of sales tax and achieving uniformity in matters of sales tax legislation and procedures in different states. Several opinions were expressed in the meeting and ultimately there was a consensus that it would be desirable to have a common approach in regard to levying sales tax not only on so-called luxury goods but also on commodities subject to lower rates of tax. It was felt that the differences in tax rates should not be more than 2 or 1% depending upon the commodities taxed at the higher rates of tax and nominal – i.e. very low – rates of tax respectively. It was also suggested that the Central Government draw up, in consultation with the Planning Commission, a list of commodities which might be considered suitable by the state governments for uniform rates, subject to marginal differences referred to above.

Because of the multiplicity of tax rates, exemptions and administrative complications arising from the operation of state sales taxes along with the Union excise duty in India, a plea has been made for the Central Government to take over state sales taxes completely and replace them with Union excise duties by compensating the loss of revenue to the state governments. This suggestion has been dismissed not merely by the state governments as constitutionally untenable but also by economists. There is also a suggestion to replace both Union excise duties and sales tax with one nation-wide value added tax. This suggestion has been thoroughly examined by D.T. Lakadawala,[15] who came to the conclusion that it is not possible to achieve all the objectives which have been achieved through Union excise duties and sales tax with a single nation-wide value added tax. Therefore India will have to live with the combined operation of Union excise duties and sales tax.

VI. CO-ORDINATION IN THE FIELD OF INDIRECT TAXATION

There is another aspect to achieving rationalisation of indirect taxes in the Indian federation. This is in regard to raising additional revenue during the Five Year Plans. The Planning Commission has been fixing additional resource targets for the states as well as for the Central Governments, but the rationale behind fixing these targets is not clear. The past trend shows that the Central Government achieved its share of the targets mostly by pushing up the rates of the Union excise duties whereas the state governments have not all been able to fulfil their goals uniformly although some have done so by pushing up sales tax rates. The tax effort criterion has now acquired some importance in the Gadgil formula which is used to distribute plan assistance among the states and hence the state governments have resorted to additional tax measures covering other taxes under their jurisdiction. Because of the nearness of the state governments to the taxpayer and the psychological impact on the taxpayer and his reaction to voting governments in and out of power, the state governments have been reluctant to tax adequately the agricultural sector through direct taxation. They have been trying to hit the taxpayer in the agricultural sector only through indirect tax which the Central Government cannot do. This fact has also been recognised by the Indirect Taxation Enquiry Committee. Indirect tax is such an "illusory" tax that it is not felt even at the local level. Therefore it would be appropriate in future to make the state governments depend more on in-

14. See for details on this concept and proposals, G. Thimmaiah, "Fiscal Harmonisation in Indian Federation", *Indian Economic Journal*, July-September 1976.
15. *Value Added Tax* (University of Mysore, Mysore, 1976).

direct tax by revising downwards the Union excise duties correspondingly while the Central Government should extend direct taxation more effectively to the agricultural sector. This is in keeping with the trend in many developing and developed countries. Thus, in the case of the Brazilian example to which the Indirect Taxation Enquiry Committee has repeatedly referred, the revenue from sales tax was 50% of total tax revenue as compared to only 17% from excise duties for the fiscal years from 1969 to 1971. A similar trend is observed in the case of France, the Philippines, etc. But in India the relative importance of the revenue from Union excise duties is more than that of state sales taxes. This trend needs to be reversed for two reasons:

(1) to strengthen the financial position of the states and thereby to ensure their fiscal autonomy, and
(2) to fit the direct and indirect taxing powers to the appropriate framework of taxpayer voting behaviour in this country so as to enable both the Central and the state governments to tap the revenue from direct and indirect taxes, respectively, without encouraging adverse reactions from the voters in a changed political situation.

Finally, the most important issue which the Planning Commission has not recognised is the rationale and mode of fixing additional taxation targets for the Central and the state governments for plan purposes. Instead of merely fixing the overall additional targets, the rationale of the composition of such overal targets should be properly examined and the Central and the state governments should decide to raise additional tax from different sources in such a way as to achieve both intra- and inter-sectoral equity in taxation and other objectives of the government. Instead of either taking over or reducing the sales tax power of the states, the Central Government should revise the rates of Union excise duties downward to a reasonable level so as to offset the high sales tax rates on the prices of commodities of general consumption. And then the Central Government should persuade the state legislatures to authorise the Central Government to levy and collect agricultural income tax. This arrangement helps to achieving intra-sectoral equity in taxation and also enables both the Central and state governments to use specific tax levers which are best suited to them in achieving their objectives.

Appendix
Structure of the states sales taxes in 1981-82

State	*Nature of sales tax*	*Administrative exemption limit*	*Dealers' registration limit*	*Rate*	*Other purpose exemptions*
1. Andhra Pradesh	(a) Multi-point sales tax	Turnover limit of 25,000 Rs. per annum	Compulsory registration limit 10,000 Rs. per annum	4% multi-point sales tax	11 categories of commodities subject to conditions and exceptions
	(b) Single point sales tax	No exemption for liability to payment of tax	No exemption limit for compulsory registration	Single point sales tax of 10 to 15%	
2. Assam	Single point sales tax	Turnover limit of 12,000 Rs.	—	—	66 categories of commodities subject to conditions and exceptions.
3. Bihar	(a) Multi-point sales tax				
	(b) Single point sales tax	Turnover limit of 50,000 Rs.	Registration limit of 50,000 Rs.	(a) General sales tax rate of 8% (b) Single point sales tax of 2 to 17% (c) 10% surcharge on sales tax	80 categories of commodities subject to conditions and exceptions
4. Gujarat	Double point sales tax	(a) Turnover limit of 30,000 Rs. (b) For manufacturers it is 30,000 Rs. (c) For importers it is 20,000 Rs. (d) For purchaser it is 50,000 Rs.	—	General sales tax rate of 4%	53 categories of commodities subject to conditions and exceptions

State	Nature of sales tax	Administrative exemption limit	Dealers' registration limit	Rate	Other purpose exemptions
5. Haryana	Single point sales tax	(a) Turnover limit of 40,000 Rs. (b) For manufacturers it is 10,000 Rs. (c) For restaurants it is 25,000 Rs.	—	—	56 categories of commodities subject to conditions and exceptions
6. Himachal Pradesh	Single point sales tax	Turnover limit of 40,000 Rs. and for manufacturers it is 10,000 Rs.	—	(a) General sales tax rate of 7% (b) Surcharge of 10% on sales tax	NA
7. Jammu & Kashmir	—	(a) Turnover limit of 50,000 Rs. (b) 100,000 Rs. Halwais, bakers, dhabawallar and hoteliers	Registration limit of 15,000 Rs.	General sales tax rate of 6%	—
8. Karnataka	(a) Multi-point sales tax	Turnover limit of 35,000 Rs. of turnover per annum	Registration limit of 15,000 Rs.	All multi-point goods to be taxed at the rate of 5%	44 categories of commodities subject to conditions and exceptions
	(b) Single point sales tax	Turnover limit of 35,000 Rs. per annum	Compulsory registration limit of 15,000 Rs.	—	—
9. Kerala	(a) Multi-point sales tax	Turnover limit of 50,000 Rs.	Compulsory registration limit of 50,000 Rs.	(a) General sales tax rate 4% (b) Surcharge on sales tax-payable by dealers with turnover in excess of 1,000,000 Rs. is 10% (c) The compound rate of tax for dealers with turnover ranging between 25,000 Rs. and 30,000 Rs. is 2%	16 categories of commodities subject to conditions and exceptions
	(b) Single point sales tax	Turnover limit of 15,000 Rs.	Compulsory registration limit of 15,000 Rs.		
10. Madhya Pradesh	Single point sales tax	(a) Turnover limit for importers 20,000 Rs. (b) For manufacturers it is 30,000 Rs. (c) For purchaser it is 50,000 Rs.	—	—	58 categories of commodities subject to conditions and exceptions.
11. Maharastra	Double point sales tax	(a) Turnover limit of 30,000 Rs. (b) For manufacturers it is 10,000 Rs. (c) For surcharge on sales tax turnover limit of 1,000,000 Rs.	—	—	—

State	Nature of sales tax	Administrative exemption limit	Dealers' registration limit	Rate	Other purpose exemptions
12. Nagaland	Single point sales tax	Turnover limit of 12,000 Rs.	—		46 catagories of commodities subject to conditions and exceptions
13. Orissa	Single point sales tax	(a) Turnover limit of 10,000 Rs. (b) For manufacturers it is 25,000 Rs.	—	General sales tax rate of 6%	40 categories of commodities subject to conditions and exceptions
14. Punjab	Single point sales tax	(a) Turnover limit of 40,000 Rs. (b) For manufacturers it is 40,000 Rs. (specific) (c) For restaurants it is 25,000 Rs.		General sales tax rate of 7% Additional sales tax on 2%	87 categories of commodities subject to conditions and exceptions
15. Rajastan	Single point sales tax	(a) Turnover limit of 10,000 Rs. for importers (b) Turnover limit of 30,000 Rs. for others (c) For cooperative stores etc., it is 25,000 Rs.		General sales tax rate of 8% on some commodities	N A
16. Tamil Nadu	(a) Multi-point sales tax	Turnover limit of 50,000 Rs. for compounding of sales tax 100,000 Rs.	Compulsory registration limit of 30,000 Rs.	(a) General sales tax rate 4% (b) Surcharge in corporation limit and 32 Kms. around Madras city is 10% (c) Multi-point sales tax is 5%	N A
	(b) Single point sales tax	No exemption for liability to pay tax	No exemption for compulsory registration	Single point sales tax rate in the range of 3.5 to 12%	
17. Uttar Pradesh	(a) Multi-point sales tax	Turnover limit of 50,000 Rs. for manufacturers			84 categories of commodities subject to conditions and exceptions
	(b) Single point sales tax	Turnover limit of 12,000 Rs. for others			
18. West Bengal	Single point sales tax	Turnover limit of 50,000 Rs.	—	(a) General sales tax rate of 8% (b) ½% on dealers whose turnover exceeds 5,000,000 Rs. and 1% on whose turnover exceeds 10,000,000 Rs. (c) A purchase tax of 2% on purchases made by the contractors if the turnover exceeds 5,000,000 Rs. and 1% on turnover above 200,000 Rs. up to 5,000,000 Rs.	

IRELAND:

Budget 1983-84

Extracts from the Budget Speech pronounced by Mr. A. Dukes, Minister for Finance pronounced on 30 June 1982.

See for detailed information on Irish taxes *Supplementary Service to European Taxation, Taxation of companies in Europe* and *Value added taxation in Europe* published by the International Bureau of Fiscal Documentation.

. . .

I referred earlier to the Government's commitment to achieve a better distribution of taxation and I will now turn my attention to the individual tax measures which form part of today's Budget. Before doing so, I should like to outline briefly the Government's overall approach to taxation and to comment on the First Report of the Commission on Taxation.

There is understandable concern at the present burden of taxation, a concern increased by a widespread feeling that this burden is unfairly distributed . Unfortunately, the imbalance in the State's finances does not allow tax concessions on any scale in this Budget and, indeed, it is necessary to raise additional taxation if current services are not to be curtailed to an unacceptable extent.

We can, however, begin to tackle the problem of tax inequity immediately. This Budget contains a number of measures which will improve the equity of the tax system and which will, I think, be seen and accepted in this light. It will be the Government's principal aim to devise tax arrangements under which the heaviest burden will be carried by those who are best able to pay.

Commission on Taxation

The First Report of the Commission on Taxation was published last July. It deals with various aspects of direct taxation and puts forward numerous proposals for change in the present system. Before turning to the proposals themselves, I should like to congratulate the members of the Commission on the excellence of their work. The Report contains a well-researched and well-presented analysis of our taxation arrangements and it will serve as a most useful reference point for the future.

The Report outlines a blueprint for a radical overhaul of the direct taxation system as we know it. Some of the more important proposals are long-term in nature: it is never easy to overhaul a long established system. Fundamental to the Government's approach to the proposals of the Commission, no matter how well-founded these may otherwise be, must be the maintenance of an adequate tax revenue yield; oterwise, our public finances would be in disarry.

The costing of the Commission's proposals is, therefore, a critical factor. This costing shows that a combined single rate of income tax and social security tax levied on all personal and corporate income at a relatively low level, as envisaged by the Commission, is not a practical proposition at this time because of the loss to the Exchequer.

This loss could be made good only by introducing the single rate at a level which would be unacceptably high for the majority of taxpayers. In these circumstances, action towards implementing the main thrust of the Commission's proposals cannot be undertaken for the time being at least. I intend, however, to keep the matter under review.

Some of the Commission's recommendations do not depend on the adoption of the general package put forward and can be considered on their individual merits. I am satisfied that changes should be made without further delay in a number of areas along the lines recommended by the Commission and I will refer to these later. The Commission are continuing their work and I look forward to receiving further reports from them later this year.

Income tax

There will be no major changes in the income tax structure of personal allowance against income tax. The question of introducing tax credits is being considered as a longer-term option; it would not be administratively possible to change over to a full tax credit system by April next.

Most rate bands and allowances will remain unchanged this year. Moreover, because of the very serious Budget situation, I have no option but to impose further taxation on income. I am, therefore, introducing a temporary 1% levy on income. It will apply to the same income categories and will be collected in the same manner as the youth employment levy introduced last year. This should yield £ 47 million in 1983 and about £ 80 million in a full year.

I think it appropriate also that the better-off be asked to make a further contribution. I am, therefore, providing for a new top rate of 65% in addition to existing rates. The 60% band will be £ 4,000 for married couples and £ 2,000 for single persons. This change should yield about £ 7 million in 1983 and £ 11 million in a full year.

I recognise that income tax levels are high at present and I would hope that, as our public finances are improved, it will be possible over the next few years to reduce the burden on the average PAYE taxpayer in particular. For the moment, however, there is no scope for major concessions.

PRSI allowance

Last year a special PRSI tax allowance was introduced as a temporary measure to improve the take-home pay of those who pay the higher rates of contribution. This allowance of £ 312 was intended to apply for the tax year 1982/83 only. As there is no opportunity for improvements in rate bands and allowances generally, I am renewing the allowance for a further year subject to a minor modification. To ensure that lower-paid families derive greater benefit, I am providing for a new social welfare family income supplement, to which I will refer later. To balance the cost of this supplement I am reducing the PRSI allowance by £ 26 to £ 286. This renewal of the allowance at the reduced level will cost £ 55 million in 1983 and £ 84 million in a full year.

Year of marriage

Since the introduction of income-splitting in 1980, couples have, in the year of marriage, enjoyed very favourable tax treatment in that they can, in effect, qualify for three times the allowances and rate bands to which a single person is entitled. The Commission on Taxation point out that this is anomalous and recommend that in the year of marriage both spouses should be taxed as single persons with the right to elect for joint assessment. In such cases the tax repayment should be reduced in the proportion that the period of marriage bears to the full year. I intend to adopt the Commission's recommendation for 1983/84 and subsequent years. This will yield £ 6 million in 1983 and £ 8 million in a full year.

Exemption limits

The general exemption limits will be increased from £ 2,200 to £ 2,400 for single and widowed persons and from £ 4,400 to £ 4,800 for married couples. These improvements and the retention of the PRSI allowance will

Companies

- Introduction of Advance Corporation Tax on distributions on or after 9 February 1983.
- Increase of tax credit on company distributions from 30/70ths to 35/65ths as of 6 April 1983.

VAT

- Standard rate up from 30% to 35% as of 1 March 1983.
- Reduced rate up from 18% to 23% as of 1 March 1983.
- Fuel: zero rate increased to 5% as of 1 May 1983 (except electricity).

Individual taxpayers

- New top rate of 65%.
- Additional 1% tax on income.
- Introduction of income-related residential property tax for persons with incomes in excess of £ 20,000 (1.5% on the excess value over £ 65,000 of such property).

Anti-avoidance

- Planning loopholes may be attacked with retroactive effect.
- Purchase and sales of Government securities to be disclosed.
- Abuse of life assurance policies and annuities will be stopped in 1984 Finance Act.

remove over 21,000 persons from liability to income tax and many more will benefit from marginal relief. The increase in the general exemption limits will cost £ 4 million in 1983 and £ 6 million in a full year. There will be no change in the age exemption limits.

Interest relief

The existing wide and generous range of income tax reliefs involves a substantial loss of tax revenue. This factor has been highligted in the Report of the Commission on Taxation. Frequently, two taxpayers of equal means pay widely differing amounts of tax because one of them makes the maximum use of the reliefs available.

In the Budget proposals of last year major changes in personal interest relief were announced. The intention at the time was to curtail this relief considerably, but in the event only modest changes were made. This was largely because of administrative problems. I am now proposing that in the case of loans taken out after today, other than a mortgage in respect of the borrower's principal private residence, there will be no income tax relief for personal interest for 1983/84 or subsequent years. In the case of existing non-mortgage loans, or exsiting mortgages on second homes, no relief for interest will be allowed after 5 April 1985.

Tax reliefs incurred on borrowing for personal and less essential purposes further narrow the tax base, provide a disproportional benefit as income increased and are very costly to the Exchequer.

Mortgage interest is an unavoidable and severe burden for many householders and it would be unfair, in the context of my other budgetary proposals, to consider the abolition of tax relief in respect of such interest. The overall ceiling for interest relief, however, at £ 4,800 for married couples and £ 2,400 for single persons, is generous and is of particular benefit to the better-off taxpayers who are on the higher marginal rates of tax. I have considered the possibility of limiting this relief to the standard tax rate, but this is not a feasible option at this stage for a number of practical and administrative reasons.

I have decided instead to reduce the ceiling to £ 4,000 for married couples, £ 2,900 for widowed persons and £ 2,000 for single persons with effect from April next. These new limits will apply to both new and existing loans. This still allows a generous concession and at current interest rates it should cover a mortgage up to about £ 30,000 for married couples. Interest on borrowings which are applied in the purchase, repair of improvement of a taxpayer's principal private residence will continue to be equated with mortgage interest for the purpose of the relief.

These changes in interest relief should yield about £ 4 million in 1983.

Self-employed

The question of placing the PAYE sector and the self-employed on an equivalent basis of assessment for income tax has been under consideration for some time and there have been indiciations in earlier Budget Statements that this problem would be resolved without delay.

The Commission on Taxation has recommended that the self-employed should be assessed on a current year basis and I intend to provide accordingly. This change, however, raises extremely complex administrative difficulties and it is not possible to bring it into effect at short notice.

I hope to incorporate the necessary legislative provisions in the 1984 Finance Bill with a view to having the new basis of assessment in operation for the tax year 1984/85. In the meantime, I will welcome the views of interested parties on the-mechanics of the proposed change, but I want to make it clear now that there can be no concessions, involving a net loss of revenue, as part of a changeover package.

Farmers

Public perception of tax equity demands that all income earners should be liable to tax on an equal footing. Up to now, however, only one-third of the farming population has been included in the tax net. There is no longer any justification for excluding the greater number of farmers from tax liability and I believe that the farming community itself accepts this viewpoint.

Accordingly, from April next, all farmers will be liable for income tax. Due to the relatively low level of many farming incomes, this extension of liability is not expect to lead to a substantial increase in tax yield in the sort term. Because of the absence of statistics, it is difficult to calculate the additional yield and the best estimate is that the removal in an increase of about £ 2.5 million in farm taxation in 1983.

It is appreciated that the extension of liability may cause problems for farmers who are brought into the tax net for the first time, particularly as many of these will have no liability because of their low incomes. The Revenue Commissions are considering various means of phasing in this arrangement, including the provisions of a simplified form for statement of the farmer's circumstances. I will return to this later.

Farmers paid an estimated £ 24 million in income tax in 1982 and the amount due in rates in the normal course in respect of 1982 would have been £ 18 million, giving an overall estimate of £ 42 million due in 1982.

Rates for full-time farmers have now been abolished and the income tax yield for 1983 would be about £ 29 million if no other changes were made. I think it is fair to expect more than this from the farming community.

Accordingly, it has been decided not to renew the present system of two payment dates for farmers, so that farmers will now be required, like other self-employed traders, to pay income tax in one instalment on 1 October.

In addition, the rates credit against tax will not apply in respect of the income tax year 1983/84. These changes, together with the extension of income tax liability to all farmers, should bring the total of income tax from farmers this year to about £ 47 million.

The 1982 Budget provided a stock relief rate of 110% for farmers. I propose to renew this special concession for a further year, in line with the Government's commitment to treat the recovery of the national herd as a major priority.

Small businesses

In the Programma for Government there is a commitment to establish a committee of enquiry containing representatives of small business and the revenue Commissioners to recommend a simplified tax regime for family businesses. I will take steps shortly to establish this committee as a matter of urgency and I intend to extend its remit to consider also the scope for simplified arrangements for smaller farmers. To this end I will invite farming representatives to participate in the work of the committee.

Capital taxation; trusts

I now turn to the question of capital taxation. It is important in the interests of equity that capital taxes should make a reasonable contribution to the overall tax requirement, provided of course they do not act as a disincentive to investment and economic growth. The yield from capital taxation is relatively low; existing taxes will yield only some £ 25 million this year.

On the other hand, there is only limited scope for increases and it would be unrealistic to suggest that a large-scale redistribution of the tax burden can be achieved simply through the imposition of higher capital taxes.

In the Programme for Government there was a commitment to a review of discretionary trusts for tax advoidance. In line with this commitment, I am examining what taxation measures may be required to ensure that discretionary trusts are not used as a vehicle for abuse. This is a complex problem and I must take care that any tax changes do not result in a penal imposition on trusts which are set up for genuine purposes. There are situations where trusts are necessary to guarantee the transfer of property under fair conditions and it would be unreasonable to impose a special tax in such cases.

I am also looking at the whole area of capital acquisition tax and its impact on the transfer of property from one generation to another. I wish to assess the social effects of this tax and to consider whether the effect might be more worthwhile if the tax were structured differently. In any event there is an obvious need to simplify the present system which has a confusing multiplicity of tax rates and classes.

Residential property

A new income-related residential property tax is being introduced and the full details will be published in the Finance Bill. In accordance with the provisions in the Programme for Government, there will be minimum thresholds of £ 20,000 income and £ 65,000 property value for liability for the tax. Those whose income is above the £ 20,000 threshold will be required to state the market values of their residential properties. The tax will be at a rate of 1½% on the excess value of taxable property over £ 65,000.

The intention is that the tax will be payable in one instalment annually and the first payment will be due next October. The income threshold will be increased by £ 1,000 in respect of each child from the fifth child upwards so as to provide a relief for larger families and there will be provision for marginal relief where incomes are only just above £ 20,000.

There will be special arrangements for houses of historical or architectural significance where there is reasonable provision for public access.

Because of inadequate statistics on the numbers likely to be liable for the new tax, it is not possible to estimate precisely what yield can be expected. I am including in the Budget arithmetic a provision of £ 10 million for 1983.

Stamp duties

The exemption from stamp duty which applies where property is transferred to a person in consideration of his or her marriage is being removed. The yield from this change is estimated at £ 0.25 million in 1983 and £ 0.5 million in a full year.

Financial institutions; deposit interest

There is an obvious need for rationalisation of tax arrangements in relation to the different financial institutions. I have examined the tax provisions for the various institutions and I now intend to bring forward a number of changes which will represent a movement towards a fairer system of taxation of deposit interest.

Interest on deposits with certain financial institutions is exempt from income tax up to certain specified limits. This exemption has led to considerable friction: in particular, those institutions which enjoy no concession argue that it is discriminatory. As a first step towards putting the tax arrangements on a more equal basis, I propose to reduce this exemption.

The existing ceiling of £ 70 will be reduced to £ 50 and the ceiling of £ 150 to £ 120. In the case of a married couple where both spouses are in receipt of interest, each will continue to qualify for a separate exemption. The new limits will apply in respect of interest assessable for 1983/84. This change will yield an estimated £ 1 million in the current year.

Building societies

The special arrangements for taxation of investors in building societies will be continued for 1983/84. The deposit ceiling below which a special reduced rate of tax applies was raised last year on a temporary basis to £ 30,000. That ceiling will be restored to £ 15,000 for 1983/84.

The Revenue Commissioners have a statutory obligation to verify this reduced rate, which is known as the composite rate, and to adjust it, as necessary, in order to ensure that the correct amount of tax is paid on building society interest as a whole. Accordingly, they will extend the arrangements for 1983/84 to those societies which agree to a survey of their investors to enable a true composite rate to be computed for the future.

Where such agreement is not forthcoming, the composite rate for 1983/84 will be 75% of the standard rate of income tax, rather than 70% of that rate as at present.

Bank levy

As regards the general question of taxing financial institutions, the bank levy must be retained for a further period, because there is no prospect of an alternative which would provide anything approaching an equivalent tax yield in the short term. The amount of the levy for 1983 will be £ 25 million. I envisage, however, that the levy will be phased out over the next few years in line with policy changes regarding the taxation of these institutions.

I am aware of the widespread criticism made in recent years regarding the level of the contribution to taxation by banks. Tax-based financing, which is the underlying cause of the present reduced level of tax payments by the banks, has fulfilled an important role in reducing the financing costs of industrial and other borrowers. The amount of tax being lost to the Exchequer, however, has been growing every year and this cannot be allowed to continue.

Accordingly, consideration will be given as to whether the tax loss can be reduced by restricting these facilities to investment which is in line with the priorities of official industrial policy.

Insurance levy

The insurance levy of 1% on gross premium income will be continued on the same basis as at present.

Company taxation; introduction of advance corporation

Income tax is not deducted from dividends paid by Irish resident companies but the tax liability of the recipients of those dividends and other distributions may be reduced by a tax credit and, in certain cases, the tax credit may in fact be paid by the Revenue to the shareholder. However, due to the availability of tax reliefs, many companies which make distributions may not pay sufficient corporation tax to cover the tax credits or indeed may pay no corporation tax at all.

In order to remedy this defect in corporation tax, I propose to change the present system so that companies will be required to make a payment of corporation tax sufficient to cover the tax credit attaching to distributions made on or after today. This payment will be known as Advance Corporation Tax and will be equal to the tax credits attaching to distributions made by a company in a accounting period less the amount of tax credits attaching to any distributions received by the ompany curing the period.

Subject to certain limitations, details of which will appear in the Finance Bill, the payment of Advance Corporation Tax will be available for set-off against the paying company's corporation tax liability in respect of its income.

The set-off will be allowed against the full amount of such corporation tax and will not be confined to the proportion of that tax which is imputed to shareholders by way of a tax credit. A corrective measure on these lines has been recommended by the Commission on Taxation and similar provisions form an integral part of the tax systems of other countries.

In order to minimise the impact on companies, the payment will be due six months after the end of the accounting period in which the relevant distribution is made, that is, on the same date as payment of the first instalment of normal corporation tax.

Advance Corporation Tax will materially affect only those companies which distribute profits but do not pay sufficient corporation tax to cover the tax credit applicable to their distributions. Manufacturing companies whose dividends carry no tax credit or a low tax credit by virtue of the Export Sales Relief. Shannon and 10% schemes will be largely unaffected by the introduction of Advance Corporation Tax.

The new measure will result in a small yield to the Exchequer this year and an increase of about £ 10 million in 1984 in the overall yield from corporation tax.

Distributions under both existing "section 84" loan contracts and such contracts which are now under negotiation and are finalised within three months from today will be excluded from advance Corporation Tax.

As a consequence of the increase in the corporation tax rate which was introduced in last year's Finance Act, the tax credit attached to distributions made on or after 6 April 1983 will be increased from 30/70ths to 35/65ths of the distribution.

Stock relief

I am extending for a further year the present arrangements for stock relief on an unchanged basis, at an estimated cost of £ 1 million in 1983. I have taken this decision after careful consideration of the representations which have been made for an easement of the clawback provisions in view of the current recessionary difficulties. The present budgetary difficulties, however, leave me with no alternative but to continue the existing arrangements unchanged.

Incentives for capital investment

The existing incentives for capital investment, in particular accelerated capital allowances for plant, machinery and industrial buildings, are substantial. They compare very favourably with those available in other countries and entail a high cost of the tax forgone.

I am concerned that a proper balance should be achieved between incentives for capital and for employment and I will be examining this in detail.

Last year an incentive was introduced for companies creating additional employment in the year to end-June 1983. As this period is not yet ended, it is not possible at this stage to assess the effect of this incentive. I am extending it for a further year in its present form.

I am terminating as from today the 20% income tax relief on dividends for shareholders in certain publicly-quoted companies. This relief, which dates from 1932, has been superseded by the major reliefs introduced in more recent years which by much reducing their tax burden, enable companies to distribute a greater proportion of profits than previously. The full-year Exchequer saving from this change will be about £ 0.5 million, with a very small saving in 1983.

The 1981 Budget announced the introduction of a special allowance of 100% in respect of expenditure incurred on the construction of moderate-cost rented residential accommodation. This allowance, which has come to be known as the "section 23 incentive", is subject to review at the end of a three-year period. I will consider whether the continuation of this incentive beyond the current expiry date is warrented when I come to preparing the Finance Bill.

Indirect taxes

The bulk of our tax revenue comes from indirect taxes, particularly excise duties and VAT. While our reliance on indirect taxes has traditionally been, and continues to be, relatively high by international standards, present circumstances demand that we must look to them for additional revenue this year.

In allocating the increases between different areas, the Government have been concerned to spread the burden as equitable as possible. I would stress, however, that the overall thrust and impact of the Budget as a whole should be the focus of attention, rather than the impact of each individual measure.

Excise duties

Increases in the main excise duties have already been introduced from 8 January 1983. The products involved are beer, spirits, wine, tobacco, petrol, road diesel and Liquid Petroleum Gas used in road vehicles. This step was taken in order to maximise the revenue gains this year from the increase and it is estimated that an additional £ 10 million revenue will accrue as a consequence.

The total yield from the increases will be £ 118.7 million in 1983 and £ 125 million in a full year. I propose later today to move a motion noting these changes, so that the House can have the opportunity to debate them.

I propose now to increase some of the other excise duties.

Hydrocarbons

The general rate of excise duty on hydrocarbon oils and LPG used other than in road vehicles was set at 7p per gallon in 1980 and has not been adjusted since. I propose to increase this by 1p per gallon to 8p with immediate effect. This increase will not apply to residual fuel oil used by the ESB, nor will there be any change in the concessionary rates already applying to residual fuel oil used by industry and to oil used by fishermen and horticultural producers.

Travel abroad

I propose to increase the foreign travel tax to £ 5 in respect of tickets purchased from 1 April 1983. This new rate will apply to travel by both sea and air.

Televisions

There will be an increase of £ 15 in the excise duty on the top category of colour TV, with prorata increases for all other categories of colour and monochrome sets, with effect from midnight tonight.

Video players

I propose to increase the duty on video players by £ 20, with immediate effect.

Licences

There will be an increase with immediate effect in the duty on excise licenses required in connection with gaming. I also propose, in the forthcoming Finance Bill, to increase the duty on excise licences on firearms, dogs, auctioneering and bookmaking. The details are set out in the "Principal Features of the Budget".

The total yield from the excise duty increases set out above is estimated at £ 7.4 million in 1983 and £ 9 million in a full year.

Oil price

Because of the world market situation, it is expected that there will be a significant fall in oil prices in the coming months. In addition, changes in the INPC's contractual arrangements and in the sources of crude oil refined by it will result in substantial cost reductions. The Government propose to absorb some of this reduction at the retail level by increasing the excise duty on petrol and other road vehicle fuels. Because of the varying factors which will influence the timing and the size of the fall in oil prices, I am not in a position at this time to state what the precise excise increases will be, or when they will be applied. I am providing for a yield of £ 15 million this year from this source. The Dail will, of course, be given an opportunity to debate these increases.

VAT drastic increase

Value-added tax has the advantage of applying to a wider range of goods and services than the excise duties, which bear rather heavily on a small number of specific products. The scope for imposing substantial real increases in excise duties is very limited at this stage, so the necessary additional revenue must be sought from increases in the existing VAT rates and widening the coverage of VAT.

Standard rate

It is proposed to increase the standard rate of VAT from 30% to 35%.

Reduced rate

The low rate of VAT will be increased from 18% to 23%. However, the effect of this increase on beer, spirits, wine, cigarettes and tobacco will be offset by a corresponding reduction in the excise duty, so that in general there will be no change in the retail price of these goods.

As in the case of other recent increases in this rate, an effective deferment of the increase to 31 December 1983 will be allowed in respect of accommodation and car and boat hire provided to non-residents under the terms of fixed-price contracts entered into before 1 January 1983.

The 3% effective rate of VAT, which applies to building and certain agricultural contracting services, will be increased to 5%.

Fuel

Fuel, which is zero-rated at present, will be charged to VAT at 5%, apart from the supply of electricity. The existing rebate of VAT for fishermen will be extended to cover VAT on fuel.

The flat-rate VAT rebate for unregistered farmers will be increased from 1.8% to 2.3%.

These increases will take effect from 1 March 1983, apart from the 5% rate on fuel which will operate from 1 May 1983. The net additional revenue, after allowing for compensating excise duty reductions on beer, spirits, wine, cigarettes and tobacco, is estimated at £ 131.4 million in 1983 and £ 227 million in a full year.

I am aware that many questions arise in respect of the present VAT structure, which was designed at a time when the VAT rates were much lower. I expect that the Commission on Taxation will be covering VAT in one of its further reports and, in the light of its recommendations, I will review the system in detail.

I accept also that high VAT rates may affect the competitive position of registered traders compared to unregistered traders. I propose to examine this problem with a view to including any necessary legislative changes in the Finance Bill.

VAT ON IMPORTS

I am aware of the problems which the changes introduced last year in the arrangements for payment of VAT on imports have caused for industry and business generally. The Government are committed to resolving these problems as soon as it is feasible to do so. While there is little continuing revenue yield from the new system, there would be a substantial loss of revenue were it dismantled. Given the present financial constraints, it is not possible to make major changes in this area at this stage.

I propose, however, to make a concession for those who are primarily involved in manufacturing for export. Firms which export 75% or more of their production will be allowed to import their raw materials and components without payment of VAT from 1 April 1983. This will reduce Exchequer revenue by £ 12.3 million in 1983. Details of how this concession will operate will be announced by the Revenue Commissioners.

Road Tax

I am proposing increases in road tax rates for a number of categories of vehicle. The annual rates of road tax on cars not exceeding 12 horse-power will be increased by £ 2 per unit of horse-power, while the rates for cars over 12 horse-power will be increased by £ 3 per unit. Rates for goods vehicles will be increased by about 10%, on average. There will also be increases in the rates applying to a number of other categories of vehicle.

In addition, I propose to double first registration charges for all vehicles. Charges for trade licences will also be doubled. Finally, annual driving licence fees will be increased by £ 1, with corresponding increases in the fees for three-year and provisional licences. Details of all these increases are set out in the "Principal Features".

The effective date of these changes will be 1 April 1983, except for trade licence charges, which will apply from 1 January 1984. The additional revenue from these road tax measures is estimated at £ 16 million in 1983 and £ 21 million in a full year.

Before I leave the subject, I wish to refer to the question of evasion of road tax. The maximum fines for evasion were, on average, doubled last year. The Garda Siochana will vigorously pursue their campaign to detect evaders. The effectiveness of this campaign will be enhanced by recently introduced regulations which tighten up the provisions governing registered ownership of vehicles.

Evasion and avoidance

Considerable progress has been made in recent years in countering tax evasion and avoidance and there have been some notable successes. While it is not possible to estimate the precise extent of these practices, it is evident that they are widespread. There seems litte doubt that many of the problems associated with raising adequate taxation would be overcome if evasion and avoidance were brought under public control.

There is considerable disquiet about the level of tax evasion in particular. It is important that this disquiet should be matched by a determination to counter evasion effectively. The strengthening of legal powers for dealing with evasion should certainly yield results but this approach must be balanced against the necessity to protect the interests and privacy of the honest taxpayer. I would prefer that we would beat this problem through the weight of public attitudes but this alone may be insufficient. I am therefore introducing a number of measures today which will help to counter evasion.

Tax avoidance has become a veritable industry in its own right and it is clear that there is a considerable loss of revenue from artificial transactions designed to avoid tax. Tax planners who engage in these activities can expect that greater attention will be given in future to closing off loopholes which they exploit. They would be unwise to assume that anti-avoidance legislation will invariably apply from a current date only.

Anti-evasion branch

The Revenue Commissioners have recently set up a special anti-evasion branch which will be responsible for the overall coordination of anti-evasion work. In the new branch the emphasis will be on prosecutions rather than monetary settlements. I am confident that the new organisation will improve significantly the effectiveness of the campaign against evasion and I shall be monitoring its progress with interest.

Penalties

Last year the monetary penalties for many of the tax offences were increased. I am not satisfied, however, that the present code provides adequate sanctions against those who deliberately provide false information about their tax affairs or deliberately submit incorrect returns or accounts.

For this reason I intend to provide in the Finance Bill for a term of imprisonment of up to two years, in addition to or as an alternative to a heavy monetary penalty, on conviction or indictment for major tax offences involving deliberate fraud. Where a company has committed an offence, the new penalties can be applied to the officers of the company involved in the offence.

I am introducing a number of other changes which will help to curb evasion and avoidance.

For the future the purchase and sale of Government securities must be disclosed in tax returns. In addition, nominee holders of Government securities will be required to disclose particulars of transactions to the Revenue Commissioners.

Deposits

In order to counteract evasion through the practice of spreading deposits over a number of accounts, the disclosure limit for bank interest is being reduced from £ 70 to £ 50. The new threshold will apply in respect of deposit interest paid in the twelve-month period ending today. I am also providing that in future, declarations of non-residence will have no effect where the bank is not satisfied as to the *bona fides* of such declaration.

Investment schemes

Because of the favourable tax concessions available, there is a considerable market for investment schemes linked to life assurance or purchased life annuities. In some instances, however, these have led to blatant abuse where schemes are simply tax avoidance devices. I want to serve notice in good time that provisions will be included in the 1984 Finance Bill to counteract these abuses. These provisions will be designed to ensure that reliefs are available only in respect of investments linked to genuine life assurance policies or annuities.

Tax appeals

In order to speed up the processing of tax appeals, which are now frequently subject to undue delay, I am introducing a change in the existing procedures. There will be stricter provisions for the admission of late appeals and the Appeal Commissioners will have the power to determine that an assessment has become final and conclusive where evidence, such as returns, accounts or statements, has not been submitted to the Inspector of Taxes, by a date previously specified by the Appeal Commissioners. Where an assessment has become final and conclusive in such circumstances, the appellant will not have a right to a rehearing by the Circuit Court.

Publication of names

Tax evaders have up to now been protected by a cloak of anonymity except where convicted in open court. I think this is unfair to the large majority of taxpayers who comply with the law. Accordingly, I propose that for the future the Revenue Commissioners will publish annually a list of persons and companies who have been convicted of a tax offence or with whom settlements have been reached in the larger back-duty cases involving default by the taxpayer.

Publication will not apply where settlements are made and agreed amounts paid before the end of 1983 or where there is a full and voluntary disclosure in advance of any investigation. To some, this may seem a radical innovation but in fact it is accepted in a number of countries.

I am also reviewing the reporting arrangements for payments to individuals and companies by Government Departments and public authorites to ensure that the necessary details will be available to the Revenue Commissioners so that those who benefit directly or indirectly from such payments will pay the appropriate tax on such income.

The package on evasion and avoidance which I have outlined above will, I expect, have a major impact and will increase tax yields substantially. While it is not possible to make a precise estimate of what additional yield might result this year, I would expect it to be not less than £ 20 million.

Duty-free facilities

The Government are very concerned about the growing number of consumers who are legitimately buying goods outside the State, either "duty-free" or otherwise. This transfer of purchasing power outside the State reduces the level of domestic economic activity and is having a particularly severe impact on certain trades. It also reduces Exchequer revenue and means that taxation generally must be set at a higer level than would otherwise be necessary.

The basic cause of these developments is undoubtedly the difference in prices, with the level of tax being a major factor for many goods. Our tax level, however, and its distribution between the various sectors, must be determined primarily in the light of our own needs and preferences, rather than by reference to tax rates elsewhere.

There is one specific measure I propose to introduce in this area. The amount of goods bought in duty-free shops which travellers arriving from other EEC countries may bring in with them without payment of tax will be reduced from 1 April 1983, to the same level as that now applying to travellers arriving from non-EEC countries.

This means in particular that the allowance for spirits will be reduced from 1½ litres to 1 litre and for cigarettes from 300 to 200. Most other EEC countries already apply this reduced allowance. It is estimated that the gain to the Exchequer from additional purchases in the State because of this measure will amount to £ 7 million in 1983 and £ 10 million in a full year.

This change will not affect the amount of duty-free goods which departing travellers, including tourists, may purchase. This is determined by the tax-free allowance in the country to which they are travelling.

Smuggling is becoming an evergreater problem. The Government will give urgent attention to combating it with all the resources at their command. I will be glad to receive any proposals which the various trading groups directly affected may wish to put forward as to practical means of overcoming this probem, and will be available for early discussion on such proposals.

FIJI:

Budget 1983

Extracts from the Budget Speech pronounced by the Hon. Charles Walker, Minister of Finance, on 12 November 1982.

A detailed discussion of the Fiji tax system will appear in supplement 23 (now at the printer's) to the Bureau's publication TAXES AND INVESTMENT IN ASIA AND THE PACIFIC.

. . .

One hundred and fifty percent of private contributions to the Fiji Visitors Bureau will be tax deductible.

Ships built for the tourist industry will be granted investment allowances similar to those granted to hotel investors. This measure will also help stimulate the local shipbuilding industry. Government is also studying the possible adoption of a shipbuilding financing package similar to those in Singapore and Malaysia.

A number of other changes to the Income Tax Act are being introduced and these are set out in the Income Tax (Amendment) (No. 3) Bill which I will move later. The age at which a taxpayer will be entitled to age allowance is being reduced from 65 years to 55 years and the notional allowances before abatement of the age allowance are being increased. This will enable pensioners to better cope with the reducing value of their pensions. Also, the widow's allowance of $600 will remain so long as her income does not exceed $2,000 (from $1,200 at present).

Maximum deductions for voluntary contributions to the Fiji National Provident Fund are being raised from $240 to $480.

To further promote energy savings, a person who acquires a solar appliance made or assembled in Fiji may claim a deduction of 20% of such expenditure or $200, whichever is less.

To bring video tapes into line with cinematographic films, payments for video tapes will be made subject to withholding tax.

A number of tidying up amendments are also proposed. One is to empower the Minister to waive or reduce royalty withholding tax where he is satisfied that it is in Fiji's economic interest to do so. The definition of withholding tax is being amended to bring royalty withholding tax within the scope of the definition. An amendment will provide for interest to include discount. The definition of resident is being amended to correct a printing error and to relate the resident status of a company to the place where "practical" management takes place.

Government had made the commitment to vary export taxes depending on the state of the industry concerned. With the depressed markets facing the sugar and coconut industries, the 2% export duty on sugar and molasses will be removed as will the 2% duty on coconut oil and 1% duty on gold. These will mean revenue foregone of $2.8 million.

Cinema operators are having to contend with changing entertainment patterns. Their audiences have fallen away drastically. To help them adjust, duty on films they hire or buy is being removed.

To raise additional revenue and correct some anomalies, import and excise duties are being raised on a number of items the details of which are set out in the Customs Tariff (Amendment) and Excise (Amendment) Bills I shall introduce later this morning. The major measures are as follows:

(1) Motor spirits – up 2 cents to 16 cents per litre and that used in premix up by 6.5 cents to 8 cents per litre.
(2) Automotive distillate – up by 3 cents to 5 cents per litre.
(3) Spirits – up by $2 and $3 per litre for under and overproof respectively.
(4) Vehicles – up by 10% for passenger vehicles up to 2,000 c.c. and by 40% for those in excess.

Excise duties are being raised as follows:

(1) Local beer – up by 4 cents to 44 cents per litre.
(2) Local cigarettes – up by an average of 2.75 cents for 10 cigarettes.
(3) Local tobacco – up by an average of $2.94 per kg.
(4) Local spirits – up by $1 per litre for underproof and by $2.50 per litre for overproof.

The net effect of the new measures is additional revenue of $5.2 million. This will hold the operating deficit to $27.7 million, a long way short of the balance we have achieved in the past. Nevertheless, by keeping a tight rain on imports and pursuing financial restraints domestically, we can weather 1983.

PAPUA NEW GUINEA:

Budget 1983

Extracts from the Budget Speech pronounced by Phillip Bouraga, M.P. on 9 November 1982.

. . .

Effective from January 1st, 1983, the Government is introducing a duty rebate system whereby all commercial ship-owners will be able to claim a refund, twice a year, of two toea for every litre of diesel consumed by their vessels over that period. This rebate will amount to approximately 50% of the import duty included in the purchase price. Effectively, they will be paying duty at a rate of 10% only, instead of the 20% paid by other consumers of diesel fuel. Details of the rebate scheme will be available from the Bureau of Customs head and regional offices.

The rebate should assist the depressed local fishing industry and also reduce costs of Papua New Guinea's coastal shipping service, upon which the out-lying ports are so dependent for the distribution of production and consumer goods.

I have three other energy-related measures to announce: I am concerned about the adverse impact of diesel fuel costs on the operating costs of local industry. As a means of relieving that cost, a reduced rate of duty of 10% will now be applicable to industrial diesel fuel, a petroleum product which is not suitable for automotive use and presently little used in Papua New Guinea. This is the same "base" rate of duty applicable to heavy fuel oil. I am hopeful that if the use of industrial diesel fuel is an attractive option for local industry that the oil companies will respond to the perceived demand by offering to supply the product to the local market.

Secondly, the rate of import duty on another petroleum product, namely liquid petroleum gas, or LPG, presently zero, is to be increased to the "base" rate for petroleum products of 10%.

Thirdly, Government intends to introduce a sliding scale of import duties for passenger motor vehicles related to the engine capacity of the vehicle. Thus vehicles with larger engine capacity and hence higher petrol or diesel consumption will incur higher rates of import duty than vehicles with smaller engine capacity. This measure is intended to encourage a move towards smaller, more fuel-efficient vehicles, and thereby should have a positive effect on the conservation of imported petroleum products. Thus, for cars less than 1100 cc., duty will remain at 70%, while for cars in excess of 2000 cc., duty will increase to 110%. Three intermediate capacity ranges will have import duties of 80%, 90% and 100% respectively. This measure is expected to generate an additional K1.5 million and should markedly increase the Government's rate of cost recovery in the land transport sector.

Thus, energy and transport related measures will raise just over K1 million net of the cost of rebates to marine users of diesels.

The second group of revenue measures, Mr. Speaker, will principally affect those members of the community most able to pay them.

Beer excise

Strong price competition in the brewing industry over the last 12 months or so has resulted in a sizeable drop in excise duty collections because duty rates for the last two years have been set on a value basis. Revenue loss for calendar 1982 is projected to be over K3 million. The Government has therefore decided to have excise duty on beer revert to a toea per litre basis, initially set at 58,5 toea per litre. And in addition, to link the unit of duty to movements in the consumer price index with automatic adjustments occurring every year.

Additional revenue of about K2.5 million is expected, with the resulting increase in retail price varying between the brands, but within the range of 40 toea to K1.10 per carton approximately.

Cigarettes

Excise duty on locally produced cigarettes is to increase to K20.10 per kilogram, so generating additional revenue of approximately K770,000. The retail price of a pack of 20 will increase by about 3 toea.

Soft drinks

Excise duty on locally manufactured soft drinks has not increased since 1979. Excise duty is to be raised to 13 toea per litre, adding about 1 toea to the retail price of a small bottle of lolly-water. Additional revenue is projected at K700,000.

Luxuries

Import duties on all "luxury" goods in the tariff schedule, for example, jewellery, electrical appliances, cameras, projectors, clocks and tape records, will be increased by ten percentage points. For most goods, which are listed in the accompanying legislation, the new tariff level will be 80%. This measure will generate revenue of about K610,000.

In addition, the "luxury" goods category will now be widened to include six types of goods which to date have enjoyed inexpensive access to the PNG market. Import duty rates on domestic deep freezers (excluding refrigerators), electronic games, non-chocolate confectionery and playing cards, will all increase to 80%. Import duty rates on recorded video tapes, and satellite receiving antennae and associated equipment, will increase to K5.50 per tape and 50% respectively. The inclusion of these 6 items at these rates will result in an additional K480,000 revenue.

Spirits

Import duties on all alcoholic drinks and cigarettes will also rise. Adding about K1.20 to a standard bottle of spirits and about 30 toea to a bottle of table wine, this will yield an additional K640,000.

Other import duties

Other minor increases in import duties on selected goods are as follows: air-conditioners to 30%, instant coffee to 30%, non-wooden prefabricated buildings to 17½%, mineral and aerated waters to 77 toea per litre, "cab-chassis" trucks to 15%, coin-operated amusement machines to 80%, lawn mowers to 30%, pure fruit juices to 20%, and cordials and squashes to 20 toea per litre. All these measures either correct existing anomalies or else maintain parity with announced excise duty increases in the equivalent locally produced product. The cordials and squashes category will now explicitly include all artificial fruit juice drinks. However industrial fruit concentrates used by the local soft drinks will now be subject to a zero rate of import duty. This group will generate about an additional K1.5 million in a full year.

Accumulated profits tax

The only revenue measure to be introduced this year which impacts directly on income also serves to close a growing means of tax avoidance. It is a fact that the Income Tax Act does not compel private companies to distribute a given proportion of their profits each year to their shareholders. This is in recognition of the fact that retained profits are more likely to be reinvested within Papua New Guinea than are distributions of dividends to domestic and foreign shareholders.

However, the lack of such a provision allows shareholders to legally avoid dividend withholding and personal income taxes by accumulating assets within the company in the form of retained profits, which upon sale of the company as a going concern, or upon sale of a shareholding, result in a tax-free capital gain in the hands of the shareholder or shareholders.

It is therefore proposed to impose a tax at the rate of 15% (equal to the current rate of dividend withholding tax) on the increase in retained earnings attributable to any shareholding of 20% or more in private companies. At time of sale of such shareholding, the tax would not be levied against the godwill component of any sale price.

I believe the introduction of this tax will restore a degree of equity with the existing taxation of profits distributed as dividends. The proposed rate, of course, is less than the marginal rates of personal income tax for the vast majority of private shareholders. Revenue from this measure is difficult to estate, but is projected at approximately K500,000 for 1983.

I also intend to remove the exemption from general import levy enjoyed by imported advertising matter. This exemption discriminates against the local advertising industry for no good reason.

Migration services

Parliament recently passed a Bill allowing the

Department of Foreign Affairs and Trade to levy fees for the migration services that it provides. In future, consumers of the services will be required to pay, thus allowing the Department to recoup the administrative costs of providing the services. A scale of fees has been prepared for a wide range of services currently supplied free of charge. Approximately K300,000 will accrue as a result.

Betting tax

I have noticed with concern the dramatic increase in horse gambling that has occurred over the last five or six years. And in particular by Papua New Guinea punters. It is of concern to me that horse gambling turnover in Papua New Guinea exceeds K40 million each year, about 2½% of Papua New Guinea's Gross Domestic Product. I am conviced this sum can be put to far more productive use. Furthermore, I believe the practice to be fundamentally undesirable and accordingly the Government intends to impose a sliding scale of stamp duties on betting tickets according to the size of each bet. Thus, on individual bets up to K10, stamp duty will be 50 toea (per ticket), for individual bets exceeding K10 and up to K50, stamp duty will be 1 kina per ticket and for individual bets exceeding K50, stamp duty will be 2 kina per ticket. Revenue will depend on the impact on betting activity but is conservatively estimated to yield K2.2 million.

In conjunction with the Minister for Lands, I have also undertaken a comprehensive review of all fees charged by the Department for the provision of its range of services. The resultant increases in fees will raise about K100,000.

The international departure tax will be reduced from K20 per adult to a flat K10 for all persons presently subject to the tax. I believe tourist traffic to Papua New Guinea has suffered as a result of the high level of tax imposed by the previous Government in its last Budget.

In summary then, the new measures I have announced will raise K10.6 million net of rebates and reductions in existing rates.

I now wish to address those revenue measures which will flow to the Provincial Governments under the Organic Law.

Commercial vehicle registration fees

Commercial vehicle registration fees have not been increased since 1979, and furthermore, they have always been too low when compared to passenger car registration fees, in relation to the road damage inflicted by large vehicles. At present, several classes of commercial vehicles pay less than the smallest passenger car. Hence, commercial vehicle registration fees are to increase by between K40 and K250, depending on vehicle weight. I estimate that truckers operating costs will increase by about ½ of 1%. This measure is another step towards the goal of recouping all current and capital costs of the land transport sector by way of user charges. Additional revenue is estimated at K1.38 million, to be distributed to Provincial Governments.

...

Investment and financial incentives

Mr. Speaker, I wish to talk briefly about the Government's package of investment incentives. For some years, Government has attempted to devise investment incentives which help overcome specific bottlenecks or constraints faced by potential investors. For example, the export incentive scheme for manufactured goods was introduced because the Government believed that investment in import substitution industries would be facilitated if access to export markets were also encouraged. The partial exemption of corporate profits from income tax, offered under the scheme, alleviates the corporate costs of undertaking an export drive.

Likewise, the infant industry loan scheme offers a Government standby loan facility for major projects on unsecured and subordinated payment terms, where investors can identify possible cash flow problems in the early years of the project, in particular those arising from likely import competition, or from import prices where market protection is offered by Government in return for import parity pricing.

Again, the feasibility studies contribution scheme acknowledges the high costs and risk associated with obtaining project feasibility information prior to an investment decision. Accordingly, Government can finance 50% or K100,000, whichever is the lesser, of the cost of a formal feasibility study.

These and other investment incentive measures are available, Mr. Speaker and I am concerned that they have not received sufficient publicity to date. I therefore encourage all interested parties to examine what assistance is available from Government, either by application to NIDA, the Department of Finance, or the new Department of Industry.

Perhaps inevitably, Mr. Speaker, there have been calls for more wide ranging investment and financial incentives to be offered by Government to industry. Before announcing new increases for 1983, I want to highlight to the community the expected cost to the national Budget, of the package of existing incentives. The cost, of course, arises out of foregone company tax revenue, and consists of the following elements:

The so-called 40B exemption, whereby national companies enjoy a 5-year holiday in respect of 50% of their profits:
Cost: K400,000.

The exemption from company tax for the first K50,000 of profits of wholly nationally-owned companies:
Cost: K1.2 million.

The double deduction from income of wages and related costs associated with apprenticeship training:
Cost: K1.25 million.

The export incentive scheme for manufactured goods:
Cost: K20,000.

Accelerated depreciation provisions (admittedly recovered in later years, but nonetheless a cost in the current year):
Cost: K700,000.

The 100% deduction in year of purchase of cost of solar water heaters:
Cost: K600,000.

These measures total nearly K4.2 million which is 10% of our estimated 1982 company tax collections. I suggest, Mr. Speaker, that this is a generous proportion of our total company tax collections to forego in order to stimulate new investment.

Furthermore, this sum does not include the subordinated loan support provided by Government to Ramu sugar under the Government's infant industry loan scheme. In addition to the K2 million presently outstanding, a further K4 million will be extended to the project in 1983.

Mr. Speaker, the Government will improve four existing fiscal incentives in 1983. Firstly, the export incentive scheme for manufactured goods presently exempts from company tax all of the profits related to the growth in export sales in the current year over average export sales for the preceding three years. However, the benefit cannot presently be enjoyed by a company which makes profits on its export operations but nonetheless makes a loss on its operations. It is therefore proposed to allow companies to carry forward the benefit accruing under the scheme for a period of seven years, provided applicant companies can demonstrate that export operations are making profits in the context of overall corporate losses in each year.

Secondly, you are aware that apprenticeship training has been actively promoted by Government over the last two years by way of a 200% deduction against income for apprentice wages and associated direct training costs incurred by employers.

The Government acknowledges the shortage of skilled Papua New Guinea manpower and the need to expand technical training across all professional categories. Hence, I now propose to extend the existing double deduction provision to all private employees engaged in professional training courses at the full range of Government training institutions, and at approved overseas tertiary institutions.

The double deduction will be limited to the wages of all employees so enrolled: and shall not be applicable to employees enrolled in correspondence courses. In addition, the existing provision in respect of apprenticeship training shall now be restricted to apprentices' wages.

Over time, increased training activity will lead to improved productivity of the Papua New Guinea labour force as well as a steady acceleration in the rate of localisation, particularly in the private sector.

Thirdly, I propose that the existing 100% write-off in respect of agricultural development expenditure be extended to include capital expenditure on the construction or improvement of plantation labourers' accommodation. To be eligible for this favourable tax treatment the buildings constructed or improved upon must be solely for the accommodation of national workers earning less than K20 per week.

Finally, I propose to remove two sectors from the list of economic sectors eligible to enjoy accelerated depreciation of long term capital plant and equipment. I believe the original intention of this tax provision was to foster productive investment in the local economy. The business services and community services sectors do not undertake strictly productive investment, and hence I propose to remove them from the list of eligible sectors which will now be limited to the manufacturing, transport and communication, and building and construction sectors.

Amendments to customs legislation

I am also announcing legislative and other measures which will act to improve the effectiveness of the Bureau of Customs in its important function of collection and enforcement. You are aware that the previous Government approved the introduction of a new customs tariff classification system, a system which is both more comprehensive and easier to administer than the present tariff schedule. However, due to drafting delays, the system was not passed by Parliament during the life of the previous Government. I am hopeful that if Parliament passes the new classification system in the present sitting, that it may be implemented by the Bureau of Customs early in the new year. I estimate that its introduction will lead to more effective control and collection by the Bureau, and should result in additional revenue of about K4 million in 1983 through reduced customs avoidance.

Secondly, I propose amendments to the Imports (General Levy) Act so as to give Customs the same powers of search, seizure and refusal to deliver as they presently enjoy under the Customs Act. At the moment Customs suffer from the anomaly that as soon as customs duties are paid, control is lost over the goods, even if the general import levy remains unpaid.

Thirdly, I believe that fines under all customs legislation are inadequate. In many cases, they have not been increased since 1970 or even earlier. I therefore propose that all fines imposed under the Customs Act, the Excise Act, the Excise (Beer) Act and related legislation be trebled.

Finally, legislation is required to permit the Bureau of Customs to make rebates of duty paid (whether export duty or import duty). This will be necessary to give legal effect to the import duty rebate scheme for diesel consumed by marine users, that I foreshadowed earlier. Rebates of duty are also made at present in respect of log export duty where timber processors have exceeded their processing targets agreed with Government. Such rebates have been effected by administrative means to date, but I believe it is appropriate to give the procedure legal effect.

Finally, I wish to propose an amendment to the Income Tax Act to strengthen the powers of the Taxation Office in respect of transfer pricing. There is a large amount of evidence which suggests that transfer pricing both in respect of imports to and exports from Papua New Guinea is being practiced on a wide scale, with the result that profits, properly earned and assessable in Papua New Guinea, are being transferred abroad, and thus escaping taxation in this country. The amendment will allow the Chief Collector to regard the consideration for any subject transaction to be equal to the "arm's length price" for tax purposes, if he is satisfied that the Papua New Guinea and overseas parties are associated with each other, *and* that the price received (or paid) by the Papua New Guinea party was not a free-market or "arm's length" price that would have prevailed if the two parties had not been associated.

Conference Diary

APRIL 1983

The Taxation Institute of Australia: Sixth National Convention (including: the role of the High Court in interpreting tax statutes; taxation of technology; tax shelters and planning for the '80s). Melbourne (Australia), April 10-15 (English).

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Management Centre Europe: Leasing (including: tax aspects of leasing). Brussels (Belgium), April 18-19 (English).

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JUNE 1983

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JULY 1983

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37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 9-14 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre: 2, Nassim Road, Singapore 1025, tel. 235-1959. Telex rs 50257 aptirc (Republic of Singapore).

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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

Institut für Finanzwirtschaft und Finanzrecht an der Hochschule St. Gallen, Varnbüelstrasse 19, 9000 St. Gallen (Switzerland).

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

Institute for International Research: 57/61 Mortimer Street, London W1N 7TD (United Kingdom).

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

Netherlands Branch of I.F.A.: J.F. Spierdijk c/o Loyens & Volkmaars, Postbus 29717, 2502 LS The Hague (the Netherlands).

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Swiss Branch of I.F.A.: M.B. Ludwig c/o Schweizerische Treuhandgesellschaft, Postfach 2143, 3001 Bern (Switzerland).

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Sijbren Cnossen:

SALES TAXATION IN OECD MEMBER COUNTRIES 147

The author evaluates the various forms of sales taxation in the OECD area on a comparative basis. He concludes that the wholesale type of sales tax is becoming an anachronism. The retail sales tax and VAT are superior to the wholesale tax and the author is inclined to prefer the retail tax because of its better "visibility" and its greater resistance to pressures to increase rates.

Sylvain R.F. Plasschaert:

THE COMPARATIVELY LIMITED ROLE OF INCOME TAXATION IN DEVELOPING COUNTRIES 161

The author studies and interprets data with respect to the relative importance of income taxation in development countries as compared to industrialized countries, a field which has been less systematically covered in literature. There are indications that the imposition of income tax runs into more problems in the underdeveloped world than in industrial countries. This may be explained by widespread poverty, the predominance of agriculture and the lack of a competent tax administration.

EUROPEAN COMMUNITIES: TWELFTH COUNCIL DIRECTIVE 168

On 25 January 1983 the Commission of the European Communities published a proposal for a Council Directive under which certain expenditure which has aspects of personal expenditure will not qualify for a credit for input tax. The measure relates to expenditure on passenger cars, transportation, accommodation, food and drink, entertainment, amusements and luxuries.

Allan R. Lanthier:

CANADA: THE 1982 CHANGES TO THE TAXATION OF INTERNATIONAL INCOME 171

The author discusses two main subjects: (1) the taxation of foreign investment in Canada and (2) the taxation of income derived by Canadian residents through foreign affiliates. The 1982 changes have been largely directed towards foreign affiliate rules and they have further increased the complexity of the provisions in this field. The Canadian Department of Finance has indicated that it will review the Canadian approach to the taxation of foreign-source income so that new developments may be expected.

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UNITED KINGDOM: BUDGET 1983-84 180

Extracts from the Budget Speech pronounced by Sir Geoffrey Howe, Chancellor of the Exchequer, on 15 March 1983. The Chancellor claims that it is a Budget for the family, for enterprise and for Britain's continuing recovery.

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ADDENDUM

ZIMBABWE: WITHHOLDING TAXES

As a result of an unfortunate editorial mistake the last paragraph of the article: Zimbabwe: A Survey of Its Tax System by Mr. D.G. Murphy was omitted. The article appeared in the January issue of the *Bulletin* (pages 27-29). This paragraph which is an essential part of the survey, reads:

10. THE WITHHOLDING TAXES

The rates of the withholding taxes are:

a) NRST – 20% of dividends payable to non-residents
b) NRTI – 10% of interest from a source within Zimbabwe payable to non-resident. NRTI was introduced with effect from 1 October 1981.
c) RST – 20% of dividends payable to residents. Companies receiving dividends are not subject to the tax. RST was introduced with effect from 30 July 1981

INHALTSVERZEICHNIS

Sijbren Cnossen:

Die Umsatzsteuern in den OECD-Staaten 147

Der Verfasser vergleicht die verschiedenen Umsatzsteuerarten, wie sie im Bereich der OECD erhoben werden. Er kommt zu dem Schluss, dass die Erhebung der Umsatzsteuer auf der Stufe des Grosshandels nunmehr zu einem Anachronismus geworden ist; die Umsatzsteuer auf der Stufe des Einzelhandels oder die Mehrwertsteuer seien dieser vorzuziehen.

Der Verfasser neigt zu der Auffassung, dass die Umsatzsteuer auf der Stufe des Einzelhandels Vorteile biete, weil sie die grösste "Durchsichtigkeit" gewährleiste und deshalb besonders geeignet sei, gegen Erhöhungen Widerstand hervorzurufen.

Sylvain R.F. Plasschaert:

Die vergleichsweise geringe Bedeutung von Einkommensteuern in Entwicklungsländern 161

Der Verfasser interpretiert Daten in bezug auf die Bedeutung der Einkommensteuern in den Entwicklungsländern vis-à-vis den Industriestaaten, ein Thema, das in der Literatur bislang kaum systematisch untersucht wurde. Es gibt Hinweise darauf, dass die Erhebung der Einkommensteuern in Entwicklungsländern mehr Probleme verursacht als in Industriestaaten. Der Grund dafür kann in der weitverbreiteten Armut, der überwiegenden Bedeutung der Landwirtschaft und im Fehlen einer kompetenten Steuerverwaltung gesehen werden.

Europäische Gemeinschaften: Die 12. Umsatzsteuer-Richtlinie 168

Am 25. Januar 1983 veröffentlichte die Kommission der Europäischen Gemeinschaften den Vorschlag für eine Richtlinie, womit bestimmte Ausgaben, die Merkmale "persönlicher Aufwendungen" aufweisen, vom Vorsteuerabzug ausgeschlossen werden sollen. Dies betrifft insbesondere Personenwagen, Reisekosten, Kosten für Unterbringung, Speisen und Getränke, Unterhaltungskosten sowie Luxusgegenstände.

Allan R. Lanthier:

Kanada: Die Bedeutung der Steuerrechtsänderungen im Jahre 1982 für die Besteuerung internationaler Einkünfte 171

Der Verfasser beschäftigt sich hauptsächlich mit zwei Themen: (1) die Besteuerung ausländischer Investitionen in Kanada, und (2) die Besteuerung der Einkünfte, die in Kanada ansässige Personen durch ausländische Tochtergesellschaften erzielen.

Die Steuerrechtsänderungen im Jahre 1982 betrafen hauptsächlich Bestimmungen zu ausländischen Tochtergesellschaften, mit der Folge einer weiteren Komplizierung der entsprechenden Vorschriften. Das kanadische Finanzministerium hat zu erkennen gegeben, dass es seine Haltung zur Besteuerung ausländischer Einkünfte überprüfen will; mit entsprechenden neuen Entwicklungen ist demzufolge zu rechnen.

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Grossbritannien: Der Haushalt 1983-84 180

Anzüge aus der Haushaltsrede, die der Schatzkanzler, Sir Geoffrey Howe, am 15. März hielt. Der Schatzkanzler ist der Ansicht, das dieser Haushalt die Familien und die Unternehmen begünstigt und damit die wirtschaftliche Erholung Grossbritanniens fördere.

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SOMMAIRE

Sijbren Cnossen:

Imposition sur le chiffre d'affaires dans les pays membres de l'OCDE 147

L'auteur étudie d'une façon comparative les différentes formes d'imposition sur le chiffre d'affaires des pays membres de l'OCDE. Il conclut que le type d'impôt frappant les ventes en gros devient un anachronisme.

Les types d'impôt frappant les ventes au détail et la TVA sont supérieurs à la taxe frappant les ventes en gros, l'auteur aurait tendance à préférer la taxe frappant les ventes au détail parce qu'elle est plus apparente et résiste mieux aux pressions d'augmentation des taux.

Sylvain R.F. Plasschaert:

Le rôle comparativement limité de l'imposition sur le revenu dans les pays en voie de développement 161

L'auteur étudie et interprète les données concernant l'importance relative de l'imposition sur le revenu dans les pays en voie de développement en comparaison des pays industrialisés; un domaine peu couvert en littérature. Il semblerait que l'imposition d'une taxe sur le revenu conduise à plus de problèmes dans le monde en voie de développement que dans les pays industrialisés. Ceci peut s'expliquer par la pauvreté dispersée, la prédominance de l'agriculture et le manque d'une administration fiscale compétente.

Communautés Européennes: Douzième Directive du Conseil 168

Le 25 janvier 1983 la Commission des Communautés Européennes a publié une proposition de Directive du Conseil dans laquelle certaines dépenses ayant un caractère personnel ne peuvent donner droit à un crédit pour la taxe d'"amont". La disposition s'applique aux dépenses portant sur les voitures particulières, les transports, le logement, la nourriture et les boissons, les divertissements, amusements et articles de luxe.

Allan R. Lanthier:

Canada: Les modifications apportées en 1982 à l'imposition de l'impôt sur le revenu 171

L'auteur étudie deux sujets importants: l'imposition des investissements étrangers au Canada et celle des revenus tirés par des résidents canadiens de filiales étrangères. Les modifications de 1982 sont essentiellement concentrées sur les réglementations de filiales étrangères et elles ont en outre augmenté la complexité des dispositions dans ce domaine. Le Département canadien des Finances a indiqué qu'il reconsidérerait l'approche canadienne de l'imposition des revenus de source étrangère de sorte que de nouveaux développements sont à attendre.

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Royaume-Uni: Budget 1983-84 180

Extraits de la présentation du Budget prononcée le 15 mars 1983 par Sir Geoffrey Howe, Chancelier de l'Echiquier. Le Chancelier considère qu'il s'agit d'un Budget en faveur de la famille, de l'entreprise et de la poursuite du redressement britannique.

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Sales Taxation in OECD Member Countries

By Sijbren Cnossen

INTRODUCTION AND CONCLUSION

The sales tax is an important source of revenue in most countries that are members of the Organisation for Economic Co-operation and Development (OECD). On average, it contributes 13% of total tax revenue, or slightly more than 5% of GDP. In most member countries, the sales tax has become a permanent, relatively non-controversial fixture of the government's tax mix. The most appropriate form of sales taxation, however, continues to be subject of intensive discussion. Spain and Portugal, which contemplate joining the European Economic Community (EEC), must adopt a value-added tax. Canada has drafted legislation to move the point of impact of its manufacturers' tax forward to the wholesale stage. Australia and New Zealand are unhappy with the performance of their sales taxes. And in many non-EEC member countries, there is an on-going debate on the relative merits of the retail tax versus the value-added tax.

This paper evaluates the various forms of sales taxation found in the OECD area on a comparative basis. First, there is a broad overview of the sales taxes levied in the member countries, as well as a brief summary of the major issues that must be faced in sales tax design. This provides an appropriate background for examining the role, level, and structure of the wholesale taxes in Australia and New Zealand, in conjunction with the manufacturers' tax in Canada with which they have much in common. Next, the third section analyzes the experience of the EEC member states with the value-added tax that is extremely productive of revenue. Following, the fourth section deals with the retail taxes in North America and Switzerland. A concluding section pulls together the main arguments that may be helpful to the debate in countries discussing changes in their sales tax systems.

I conclude that the wholesale tax is slowly but surely becoming an anachronism. Because retail margins are not taxed, effective tax rates will not be uniform and competitive conditions are distorted. Excess burdens attributable to the tax tend to grow exponentially as rates are increased for revenue purposes. On economic and administrative grounds, the choice between a retail sales tax and a value-added tax is largely a stand-off, if a high yield is not a prime consideration. The value-added tax performs better if a basic rate in excess of, say, 10% is required. I am inclined to favor the retail tax because of its higher visibility and greater built-in resistance to pressures to increase rates for revenue.

I. ROLE OF SALES TAXES

Sales taxes may be imposed at one or more stages of production and distribution through which goods and services pass on their way from primary producer to consumer; accordingly, they may be called single-stage or multistage taxes. Sales taxes collected at the manufacturers', wholesale, or retail level are single-stage taxes; turnover and value-added taxes are multi-stage taxes. In sales tax design, attention must be paid to the potential economic distortions of the tax, as well as to its effect on the tax burden distribution.

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Following an overview of the various forms of sales taxation and their revenue importance, this section, therefore, dwells on the treatment of producer goods and imports, and on the coverage of consumer goods and the rate structures.

Table 1
Sales taxes in OECD Member Countries, 1983

Type of tax and country[a]	*Standard rate*[b]	*Revenue importance: In percent of total tax revenue*	*Revenue importance: In percent of GDP*
Turnover tax			
Spain	4	7	1.6
Manufacturers' tax			
Canada (Federal)	9	5	1.8
Greece[c]	7	17	4.6
Wholesale tax			
Portugal	15	16	4.8
Australia	17.5	5	1.6
New Zealand	20	10	3.2
Finland	16.28	20	7.1
Retail tax			
Switzerland	6.2/9.3[d]	9	2.8
United States (States)	2-8	7	2.0
Canada (Provinces)	5-11	6	2.1
Value-added tax			
1. EEC			
Luxembourg	10	11	4.9
Germany	13	17	6.3
United Kingdom	15	14	5.1
Belgium	17	16	7.3
Italy	18	16	5.1
France	18.6	21	9.0
Denmark	22	22	10.1
Ireland	30	15	5.4
2. Non-EEC			
Austria	18	20	8.3
Norway	20	18	8.6
Sweden	23.46	13	6.6
Unweighted average	15.1	13	5.1

Sources: Updated from Cnossen (1977a: Table 2.1 and Appendices A and B). Revenue figures relating to 1980 or corresponding fiscal years, have been drawn from OECD (1982).

a. All OECD member countries, except Japan which does not levy a sales tax, and Turkey for which recent data are not available.
b. Expressed as a percentage of the tax-exclusive value of taxable sales which is the practice in most countries. Finland and Sweden have tax-inclusive rates. The relationship between the two rates is expressed by the formula

$$t_e = t_i \frac{1}{1 - t_i}$$

where t_e is the tax-exclusive rate and t_i the tax-inclusive rate.
c. In addition, Greece levies a cascade-type sales tax with a yield of approximately 30% of that of the manufacturers' tax.
d. The 9.3% rate applies to sales by wholesalers to small retailers that are not registered for sales tax purposes.

A. Overview and revenue importance

Table 1 shows the various forms of sales taxation found in OECD member countries, the standard rates of tax that are applied, and the revenue role in the respective tax systems. The types of sales tax are listed in their approximate order of historical appearance. The oldest form, the turnover tax, originated as the alcabala in medieval Spain. Although in the late 1960s it still was the most widely used form of sales taxation in Europe, it subsequently disappeared rapidly from the scene, largely because its distributional effects, particularly with respect to exports and imports, could not be ascertained; hence it was incompatible with the goals of the EEC. In the OECD area, the turnover tax is found only in Spain, although the Greek sales tax system also has substantial turnover tax or cascade elements.[1]

Greater use is made of sales taxes imposed at the manufacturing or wholesale level; they avoid most, but not all, of the uncertain effects of the turnover tax. As the Table indicates, 6 countries levy one of either form of sales tax. As discussed below, the experience with the wholesale tax in Australia and New Zealand is closely linked to that of the Canadian manufacturers' tax. The Finnish tax is a hybrid form that combines a wholesale tax with a retail levy that has a value-added feature. The retail tax, found in 3 countries, is particularly suitable for federal tax systems, because, by definition, border tax adjustments do not have to be made. Not surprisingly, therefore, it is widely used by sub-national governments in the United States and Canada. In name the Swiss tax is a wholesale tax, but 82% of total receipts is collected through the lower rate of tax on direct sales to consumers, i.e. at the retail stage.

Clearly, the value-added tax is the most popular form of sales taxation in OECD member countries; it is found in 12 out of 22 countries listed in Table 1. In addition to the 9 members of the EEC that have the tax, 3 non-EEC countries have adopted this levy. Furthermore, upon entry into the EEC, Greece committed itself to introduce the tax before 1984, and 2 prospective members, Spain and Portugal, are actively considering its introduction in the near future. Moreover, the possibility of having such a tax has been discussed in Australia, Canada, Finland, Japan, New Zealand, Switzerland, and the United States.[2] Apparently, no OECD member country believes that it can leave the value-added tax out of consideration.

The revenue yield of a sales tax is a function of its coverage and rate. With similar coverage, the same amount of revenue can be raised at a lower rate of tax under retail and value-added taxes than under manufacturers' and wholesale taxes, because the former include all trading margins in the value for tax. Because the tax base is exceptionally broad and rates are high, the value-added tax in Table 1 is the most buoyant source of sales tax revenue, contributing on average 17% of total tax revenues in 1980, or 7% of GDP, in the countries that levy this tax. No other form of sales taxation comes even close to this high average level; rates of existing retail taxes are much

1. For a classification and overview of sales taxes in countries that are not members of the OECD, see Cnossen (1977a: 15-22), who shows that the sales tax imposed at the manufacturing stage, or, more broadly, on production, is the most widely used variant in the world.
2. See OECD (1981: 54). Outside the OECD area, the value-added tax is levied in Argentina, Bolivia, Brazil, Chile, Costa Rica, Ecuador, Honduras, Israel, Korea, Mexico, Panama, Taiwan, and Uruguay. However, the non-EEC type of value-added tax may not or only partly cover the retail stage and sometimes does not give credit for tax paid on certain fixed assets. For an evaluation of experiences until 1977, see Cnossen (1977b).

lower and the coverage of the manufacturers' and wholesale taxes is much more restricted. Also under the latter, of course, effective rates, i.e. ratios of tax to final consumer prices, are lower than nominal or statutory rates.

B. Treatment of producer goods and imports

As is well-known, a sales tax that applies to each transaction becomes cumulative and capricious in its effect on prices. The effective tax rate will differ from the nominal rate and from product to product depending upon the number of transactions involved and the value added in various stages. The classic example is the turnover tax that has widely differing effective rates, thus unintentionally distorting consumer preferences as well as producer choices, because it favors integrated over non-integrated forms of business, and self-production over subcontracting. More generally, the distributional effects of the tax are unknown.

Cumulative or cascade effects may be avoided by applying tax only once to each good on its way from producer to consumer. Under manufacturers' and wholesale taxes, capital goods, being relatively easy to identify and used primarily for business purposes, are usually exempted outright. Furthermore, under the suspension method, used in Canada, Australia, and New Zealand, manufacturers and wholesalers, registered for that purpose, can buy or import their raw materials and intermediate goods free of tax, tax being levied only when products are sold to unregistered entities, usually at the point of sale to the last wholesaler or the retailer. The subtraction technique, incorporated in the Greek sales tax, permits a deduction of taxable purchases from taxable sales. Under a closely related principle, administered at the retail level in Finland, credit is given for the tax paid on purchases against the tax payable on sales. On the whole, these techniques are about equally effective and feasible in eliminating cumulative effects, although problems occur with end-use exemptions (e.g. for transport equipment).

Under a retail tax, the taxation of producer goods can be avoided almost entirely by defining taxable transactions as sales for use or consumption, and not for resale. Some cascading may occur, because vendors of, say agricultural inputs or office supplies do not or cannot distinguish these from similar products sold to consumers. Also, capital goods are widely taxed, reflecting a deliberate choice.

Under the value-added tax, the tax credit method is universally applied to the tax paid on both inputs and capital goods. To this end, the net liability to tax is determined by permitting each firm a credit for the tax invoiced by its suppliers of intermediate and capital goods, against its own gross tax payable on sales; this technique is also known as the invoice method. A value-added tax that extends through the retail stage and that provides for a full credit of the tax paid on all producer goods is most effective in preventing cumulative burdens. More generally, in the order in which they are listed in Table 1, each sales tax discriminates less capriciously than its immediate predecessor between consumer preferences and different forms of economic organization.

Finally, an important efficiency requirement in sales tax design is that domestically produced goods and foreign made products are taxed alike, and that exports leave the country completely free of tax. The latter objective is generally fully achieved under all sales taxes, except the turnover tax for reasons mentioned above. Equal treatment of domestic and imported consumer goods is automatically attained under retail and value-added taxes, but not under manufacturers' and wholesale taxes, because the import stage differs functionally from the domestic stage at which the tax applies; generally, adjustments, such as uplifts, cannot achieve full uniformity. The treatment of producer goods, on the other hand, does not give rise to uneven treatment, because they will nearly always be imported by registered traders.

C. Coverage and rate differentiation

Inherently, there is a strong case for making the base of a consumption type sales tax as broad as possible. Preferential treatment distorts consumer as well as producer choices. With minor exceptions, all OECD member countries levying single-stage sales taxes violate this principle by not taxing services. Particularly in countries that follow the British tax system this represents a longstanding tradition. Admittedly, services that are essentially retail in nature do not fit easily into a manufacturers' or wholesale tax. In contrast, the European value-added taxes cover a broad range of services.

Exemptions and rate differentiations to influence the distributional pattern of a sales tax are somewhat easier to justify. Since the share of consumption in income declines as income rises, a sales tax imposed at a uniform rate would be regressive with respect to income. To lessen this effect, nearly all sales taxes exempt or apply lower than average rates to items that figure importantly in the household budgets of lower income groups. Examples are food products, clothing, housing, drugs, and medical services. Similarly, to introduce an element of progressivity, increased rates may be levied on articles of luxury consumption. Under single-stage but pre-retail taxes such rates are also justified to provide greater uniformity of tax to consumer price ratios. Rate differentiation is about equally feasible under most sales taxes, but the result is obviously more uneven under manufacturers' and wholesale taxes.

II. WHOLESALE SALES TAXES

As evidenced by the annual budget debates in Australia and New Zealand, pressures to increase expenditures are likely to mount in the years to come. One of the possibilities to finance these is to expand the coverage of the existing wholesale taxes that at present are little more than extended excise systems. Also, in both countries there is a growing awareness of the inequitable aspects and distorting effects of a narrow sales tax base to which an ever higher rate is being applied. At first sight, base broadening appears the thing to do, particularly since both countries have had more than 50 years of experience with the wholesale tax. Furthermore, in Canada, the Government has proposed to move the point of impact of its sales tax forward from the manufacturers' to the wholesale stage. The hope is that this will eliminate various shortcomings of the present levy.

This section surveys and evaluates these developments. It starts with a comparative review of the basic structural aspects of the various sales taxes. Following, a number of contentious issues under the wholesale tax are treated in greater detail. They relate to the value for tax, the treatment of transportation costs, and the classification of wholesalers. In a concluding comment, I suggest that other alternatives should be explored.

A. Comparative review

The Australian wholesale sales tax was enacted in 1930. As most sales taxes, it was a child of necessity. During the depression, receipts from customs duties declined, while more revenues were needed to finance increased expenditures. The Australian government made a detailed study of the Canadian levy at the time when that tax was collected at the wholesale stage. The government chose this level of imposition, because it particularly suits the taxation of imported goods. For similar reasons, New Zealand adopted the same tax in 1933.[3]

Canada introduced a single-stage sales tax in 1923. Initially mainly levied at the wholesale stage, it proved difficult to collect from numerous small trading establishments, and so it was decided to halt the licensing of wholesalers primarily trading in fully manufactured goods, and to shift the main point of impact to the manufacturing level.[4] In subsequent years the debate on moving the tax back to the wholesale stage waxed and waned. In 1956 a government-appointed Sales Tax Committee reviewed the levy, and in a broadly worded recommendation suggested that the primary impact should be shifted on to the wholesale stage.[5] Following strong opposition from the business community, however, the government did not accept the proposal.

Subsequently, in 1966, the Royal Commission on Taxation, after careful consideration of various alternatives, concluded that the tax should be shifted to the retail stage, arguing that only a retail levy could ensure full neutrality between forms of business and methods of doing business.[6] This proposal was not accepted either, and in 1975 a government Discussion Paper again opted for a shift from the manufacturing to the wholesale trade level.[7] Finally, the November 1981 budget set a date for implementing the new wholesale tax. On 13 April 1982 this date was moved forward to 1 January 1983.[8] A further postponement followed later in the year.

Table 2 provides some details on the scope of the sales taxes in Australia, New Zealand, and Canada as it relates to the treatment of producer goods, imports, essentials, and luxury goods. The base of all sales taxes is confined to goods; services or sales of real property or intangible property are not taxed. All three countries tax imports along with domestically produced or traded goods and exempt exports. However, this is where most of the similarity ends; there are major differences in tax coverage. Although each country started with a broad-based levy with only a few exemptions primarily related to unprocessed foodstuffs and producer goods, over the years the base of the Australian and New Zealand levies has been greatly eroded. In fact, outside tobacco, alcohol, and motoring these countries tax only about 10 and 15%, respectively, of total personal consumption expenditure, as compared with approximately 40% in

Table 2
Scope of sales taxes in Australia, New Zealand, and Canada, 1983

	Australia	*New Zealand*	*Canada*
Basic legislation	Sales Tax Act (No. 1), 1930	Sales Tax Act, 1933	Excise Tax Act, 1923
Level of imposition	Wholesale	Wholesale	Manufacturers
Standard rate	20%	20%	9%
Coverage of services	Not taxed	Not taxed	Not taxed
Treatment of producer goods			
Raw materials, intermediate goods	Exempt under license	Exempt under license	Exempt under license
Machinery, equipment	Exempt	10%	Exempt
Transportation equipment	Taxable	10%	Taxable
Building materials	Exempt	Exempt	5%
Taxation of imported goods	Tax-free under license, but non-licensed persons pay tax on duty-paid value plus 15%	Same as Australia, but mark-up is 25%	Same as Australia, but no mark up
Treatment of essentials			
Food products	Exempt	Exempt	Exempt
Confectionery	Taxable	Taxable	Taxable
Medication	Exempt	Exempt	Exempt
Water, fuel, electricity	Exempt	Exempt	Exempt
Soft drinks	Taxable	Taxable	Taxable
Clothing, footwear	Exempt	Exempt	Taxable
Furnishings, appliances	7.5%	Exempt	Taxable
Books, newspapers	Exempt	Exempt	Taxable
Taxation of luxury goods			
Cosmetics, perfumery	32.5%	40%	Standard rate
Jewelry, watches, clocks	32.5%	30%	Standard rate
Television sets, radios	32.5%	30%	Standard rate
Audio-visual equipment	32.5%	30%	Standard rate
Slot machines	32.5%	Standard rate	Standard rate

Source: Updated from Cnossen (1975: Table 1).

3. For an introduction to the history and basic features of the sales taxes in Australia, New Zealand, and Canada, Due (1957a: chapters VIII and IX), although somewhat out-of-date, is still worth reading. For a good analysis of the issues, see als Due (1970: chapter 4).
4. That this did not require any changes in the statutory provisions is an indication of the similarity in design of manufacturers' and wholesale taxes.
5. For a thorough review of the Committee's report, see Due (1975b).
6. Royal Commission on Taxation (1966).
7. For a detailed review of the Commodity Tax Review Group's paper (1975), see Cnossen (1975); this section draws heavily on the latter's article.
8. See Bird (1982). For an excellent analysis of the change-over to the wholesale stage, see Price Waterhouse (1982). The major changes as compared to the manufacturers tax include a 1% reduction in the standard rate (because henceforth the value for tax would include wholesale margins), the imposition of a large-retailers surtax of 15% (in order to include marketing functions shifted forward to the retail stage in the value for tax), the establishment of a formal appeals mechanism to deal with notional or determined values for tax purposes, and the treatment of contractors and repair shops as retailers (implying that they would have to buy goods on a tax-paid basis). Costs of transportation of finished goods and installation and erection costs incurred by manufacturers and wholesalers would continue to be excluded from the tax base.

Canada and nearly 70% under the Dutch value-added tax.[9]

Further study reveals that Australia and New Zealand exempt virtually all necessities (except soft drinks), although Australia does tax household furnishings, supplies, and appliances at a greatly reduced rate of 7.5%. Canada, on the other hand, taxes the latter goods in full as well as clothing, all items that figure prominently in nearly every household budget. Canada also taxes building materials, albeit at a reduced rate, which are exempted in Australia and New Zealand. It may also be noted that while Canada applies the standard rate to luxury goods (although it imposes additional excises on some of them), Australia and New Zealand apply higher rates of sales tax. Furthermore, New Zealand taxes industrial machinery.[10]

On the whole, then, there are substantial differences in the scope of the various sales taxes. The Australian and New Zealand variants are largely limited to luxury goods and a few semi-necessities. The Australian Taxation Review Committee (1975: 514) aptly characterized the situation as follows:

> The remaining sales tax (exclusive of taxes related to motoring) is scattered in small packets over other categories of consumption expenditure and constitutes a small but uneven levy upon them, too modest to deserve much consideration. Outside the area of motoring, drink and tobacco, taxes on goods and services at the Federal level can be dismissed as a trivial relic.

This conclusion deserves the limelight in full, because it implies that in these countries the alternative of a full-fledged wholesale tax emphatically is not one of merely expanding the present levy, but of introducing a completely new tax. Even though it might not be necessary to change the statutes substantially, the socio-political impact of a broad-based wholesale sales tax and the magnitude of its technical problems differ fundamentally from those of the excise system, which the present sales tax really is.

B. Value for tax

A number of vexatious technical problems must be addressed under a wholesale tax, especially because they would acquire greater dimensions under a broad-based tax. The main one is valuation. As elsewhere, the statutory definition of the value for tax is the price which goods would generally sell for if sold to a retailer in the open market on sales freely offered and made on ordinary trade terms. Probably in 85 to 90% of all cases, the actual selling price can then be taken directly as the value for tax purposes. In 10 to 15% of all cases, however, a constructive price must be established, because wholesalers sell directly to consumers. Generally, this value is the price charged to retailers where the wholesaler sells similar goods in like quantities to retailers, but experience indicates that in at least 5% of all cases specified discounts from the actual price charged to users must be established, because the wholesaler does not make representative sales to retailers.[11]

At present, Australian practice appears to allow the taxpayer nearly complete freedom with respect to the value for tax of direct sales where sales to retailers are also made. In effect, he is then permitted to substitute the lowest price. This may be tolerable under the present limited sales tax, but might lead to tax avoidance schemes under a true wholesale tax as taxpayers would make some sales to retailers on especially favorable terms in order to escape part of the tax on sales to users. A solution would be to take an average sale price related to the taxable period, but such a rule would have its own discriminatory effects. Agency arrangements and the formation of separate companies for rendering (exempt) services are other possibilities to avoid tax.

The biggest problem is encountered in establishing a discounting mechanism for direct sales to users for which representative sales to retailers are not available. Australian practice is mostly to conclude agreements between taxable firms and sales tax authorities. Similarly, under a broad-based tax, extended arrangements with appropriate consultation and modification procedures would have to be set up, whereby a standard discount based on average mark-ups would be established for groups of firms. Individual taxpayers might feel aggrieved, however, by such an approach. They could be given the right to review and appeal (not now available), but this would add to administrative burdens, and so on. In short, although discounts probably work in the right direction, they can never provide uniformity of treatment among firms or industries, because of the diversity of distribution channels. Only rough equality of treatment can be achieved.

A wholesale tax favors the private brands of department stores and other large retailers over national brands, because manufacturers of the former do not have to incur marketing costs. This means that they can sell at lower prices and pay proportionately less tax, so that tax to consumer spending ratios may differ for the same products, depending on the nature of the retail outlet. New Zealand applies a 15% uplift, but this greatly complicates the administration of the tax. Alternatively, large retailers may be required to pay a surtax as has been proposed in Canada. It should be pointed out that the differential tax burdens discussed here reflect variations in marketing functions, not the real economies associated with large-scale purchasing.

A last valuation issue concerns imports. One of the few important advantages of a wholesale tax over a manufacturers' tax is that it provides for more equal treatment of

9. The scope of the Australian sales tax is examined by the Taxation Review Committee (1975: chapter 27). For New Zealand, see Task Force on Tax Reform (1982: chapter 8). For an analysis of the Canadian sales tax base, see Bourgeois (1967). For a derivation of the value-added tax base of the Netherlands from national accounts, see Cnossen (1981a: 45-51).

10. But agricultural machinery is exempt. Some goods for use in agriculture, for example tractors, are conditionally exempt. The refund technique which is then applied has resulted in a large number of refunds, many small. This places a heavy burden on the administration.

11. Under the new Canadian legislation, three substitute values for tax have been proposed: (1) a weighted average sale price to be used if like goods sold to retailers constitute at least 15% of the total value of the wholesaler's sales in the relevant period; (2) a discounted sale price where a wholesaler sells to retailers at a discount from the sale price of like goods to consumers; and (3) a prescribed price if wholesalers sell only to end users. Rules such as these highlight the complexity of a wholesale tax as compared with a retail or value-added tax.

domestically produced goods vis-à-vis imports, because selling and promotion expenses incurred after importation are also included in taxable value. Problems still occur with respect to the importation of fully manufactured goods by non-licensed traders, whether retailers or consumers. In valuing them for sales tax purposes at the import stage, the domestic wholesale margin must be taken into account. Australia and New Zealand adjust for this by adding 15% and 25%, respectively, to the duty-paid value before calculating sales tax liability. Although such rough adjustment procedures are inevitable, nevertheless they remain highly arbitrary (and probably excessive).[12]

C. Treatment of transportation costs

One of the conflicts between neutrality and simplicity under a wholesale tax concerns the treatment of freight (and insurance) charges. Neutrality demands that there should be no discrimination between the different ways or distances over which goods are transported. This means that all outward transportation costs (incurred from the warehouse or the factory gate to the retailer's doorstep) should be included in taxable price. On the other hand, simplicity may require that such costs be excluded because they are often not known or identifiable; this would be the case where retailers make their own arrangements for shipment. For this reason, in Canada, outward freight charges either are not included in the sale price or, if separately invoiced, are not part of the value for tax.

Of course, this arrangement forms an inducement to wholesalers to locate their warehouses close to manufacturers and to manufacturers who assume wholesale functions to locate their plants close to suppliers of raw materials and partly-manufactured goods, because inward freight costs (incurred up to the point of impact) are included in taxable value. It is understood that the Australian definition of value for tax includes freight charges, unless goods are sold on an f.o.b. basis or the retailer ships the goods himself. In practice, this approach probably leads to the same result as explicit exclusion. The Taxation Review Committee (1975: 526) did not recommend any change in established practices, arguing that equity could not be achieved without sacrificing simplicity and certainty.[13]

This dictum may well retain its relevancy under a new wholesale tax. No doubt any attempt to include all costs of placing goods in the hands of retailers would meet with serious opposition. There is no reason to believe that business practices of quoting delivered prices would be extended to all transactions once freight charges are included in the value for tax. They would if there were a penal element in the mark-up that would be applied in those cases where prices are not quoted on a delivered basis. But such an element would be regarded as inequitable and probably thrown out of court. In turn, this might lead to the use of mark-ups lower than actual transportation costs which would be an inducement to quote prices on an f.o.b. basis; in other words, the tax administration would be back to square one.

On the whole, I do not think that neutrality and administrative convenience can easily be reconciled in the case of transportation costs. On balance, I would favor a continuation of present departmental rules if the wholesale tax is expanded. Canadian experience indicates that transportation costs do not average more than 3% of wholesale prices; hence the tax element is only 0.5% of the value for tax.[14] There is also the psychological point that uplifts are much less acceptable in the taxpayer's eyes than discounts, or no adjustments at all. Whatever is done, of course, some discrimination is inevitable.

D. Classification of wholesalers

Of course, not all wholesalers (including manufacturers) sell exclusively to retailers; many deal directly with users, that is, they sell at retail. Similarly, a retail merchant may also do business with other retailers, which is to sell at wholesale. Following Australian usage, when a firm sells predominantly at wholesale, it may be referred to as a "wholesaler-retailer", and when it sells predominantly at retail as a "retailer-wholesaler". The treatment of these dual firms is particularly troublesome under a wholesale tax, and it raises two issues: (1) where should the line be drawn on licensing? and (2) how should the taxable value be determined for sales made direct to users or to other retailers?

In line with practice in New Zealand, Australia puts the criterion on licensing at the 50% level, that is, if half or more sales are made to retailers, then for tax purposes the trader involved is classified as a wholesaler, and can purchase goods free of tax. Conversely, traders making less than half of their sales to retailers (in other words, half or more to users) are not licensed and consequently their whole inventory is held on a tax-paid basis.

If no adjustment were made for sales by a wholesaler-retailer to users, he would be discriminated against compared to ordinary wholesalers. In Canada, it has been proposed, therefore, that a wholesaler-retailer be permitted to adjust the taxable value of such sales to the price level of sales of similar goods to retailers, as discussed above. Furthermore, a retailer-wholesaler who would carry tax-paid inventories would enjoy an advantage because the margins on his sales to ordinary retailers are not included in the value for tax. Also in Canda, new legislation makes adjustment for this by requiring a retailer-wholesaler to be registered and to account for such

12. The mark-ups are so high because the value for imported goods for customs purposes is formulated on an f.o.b. basis, that is, no account is taken of the costs of transportation and insurance from the exporting country to the ports of entry. (Such costs are, of course, automatically included if the liability to tax arises on sale subsequent to customs clearance.) If so, one wonders whether Australia and New Zealand should not do away with this historic relic and adopt the Definition of Value of the Customs Cooperation Council which is formulated on a c.i.f. basis and, therefore, would not have to be adapted for sales tax purposes.

13. In New Zealand, separately invoiced charges were not included in the value for tax until 1982, when legislation required inclusion.

14. See Commodity Tax Review Group (1975: 34).

sales on a value-added basis, that is, only his wholesale margin would be subject to tax as is done in Finland.[15]

In my opinion, the amount of tax derived from the latter adjustment is out of all proportion to the administrative problems of collecting it. It would probably be much easier to keep retailer-wholesalers outside the sales tax net and let the wholesale margins escape tax. It might be argued that retailer-wholesalers bear an interest cost differential anyway. Only retailer-wholesalers who make substantial sales to exempt users might then be licensed, in order to limit the number of refund claims. I understand that, generally, this is Australian practice.

Finally, there is a third kind of wholesale business, namely, retailers who carry on substantial manufacturing activities. Examples are the remodeling and repairing of fur garments and the manufacturing of drapes. In New Zealand these firms are taxed on a value-added basis. After all, tax has already been paid on the materials. Again the costs of administering the required licensing and tax equalization schemes are relatively high. But such arrangements must be made whenever second-hand goods re-enter the tax circuit, even under a retail or value-added tax.

E. Evaluation

I believe that the wholesale tax was an acceptable second-best form of sales taxation in times of numerous small retail outlets that kept only poor records, and often none at all. But it is not good enough in an age of large department stores and taxpayer sophistication. A serious flaw is that services are not covered. Furthermore, by definition, no wholesale tax takes account of retail margins, so that tax to consumer price ratios will never be uniform. Effective tax burdens will be low on income-elastic goods with high trading margins, and high on necessities with relatively low margins. Higher rates of tax may adjust for this, but full equalization cannot be achieved.

Firms will be induced to push as many distribution functions forward to the retail stage as possible so that their cost will not be included in taxable value. For the same reason, the tax induces retailers to assume certain manufacturing and wholesale functions (packaging, transportation, storage, insurance, and market research) which, in the absence of the tax, would have been performed in prior stages. And, finally, systems of discounts for wholesalers who sell at retail and uplifts for private brands are certain to favor some firms and discriminate against others. It should be emphasized that all these distortions involve differential burdens that are hard to shift forward in consumer prices.

In my opinion, the inefficiencies that attend a wholesale tax are unacceptable when better alternatives such as the retail tax or the value-added tax have proven their feasibility. Surely, the wide acceptance and satisfactory operation of the Australian tax, if true,[16] should not be taken as an indicator of the success of wholesale taxes in general. With coverage as limited as it is, taxpayer complaints are bound to be few and far between. In concluding this section, attention may be drawn to the reasons why Denmark abandoned its wholesale tax in 1967. The government rejected the tax because services were not covered, producer goods could not be fully excluded from tax, and it was difficult to find a satisfactory solution for the many valuation problems that arose. Also, the government wanted to increase sales tax revenues with lower tax rates.[17]

III. VALUE-ADDED TAXATION

The second major option that countries wishing to rely more heavily on a broad-based sales tax might consider is a value-added tax of the type that is such a productive source of revenue in the EEC. Although much has been published about it, a value-added tax appears a relatively unknown form of sales taxation in countries that do not have such a tax. This section, therefore, starts with a brief analysis of the basic workings of the value-added tax.[18] This sets the stage for a description of the EEC situation, as it relates to the coverage of consumer goods, and the various rate structures. Finally, the experience with the value-added tax is evaluated. The major technical lesson is that rates should not be differentiated.

A. How does VAT work?

The design and operation of an EEC-type value-added tax may be illustrated by reference to the example in Table 3 which traces the manufacture of the typewriter on which the first draft op this paper was produced. Following the production and distribution cycle, we start with the miner who sold iron ore to the iron founder, who delivered steel to the manufacturer, who sold the typewriter to the wholesaler, who distributed it to the retailer, who in turn put it at my disposal (against cash). In each stage the value of the typewriter increased and the sales price rose accordingly.

Table 3
Basic working of a value-added tax
(in dollars)

Production or distribution stage	*Transactions* (exclusive of tax)			*10% tax*		
	Sales -	Purchases =	Value added	Gross tax -	Tax credit =	Net tax
Miner	20	0	20	2	0	2
Iron founder	50	20	30	5	2	3
Manufacturer	150	50	100	15	5	10
Wholesaler	160	150	10	16	15	1
Retailer	200	160	40	20	16	4
Consumer			200		10% tax	20

15. More specifically, in Canada this rule will apply to persons whose sales by wholesale constitute less than 30% of their total sales. Persons whose sales by wholesale comprise between 30 and 50% of their total sales have the option of applying for registration. Registration is mandatory for persons with wholesale sales above 50% of total sales. Finally, a retailer who makes more than 50% of his sales to exempt customers in the relevant period may apply for registration enabling him to hold inventories on a tax-free basis. See Price Waterhouse (1982: 17-18).
16. For this opinion, see Due (1957a: 194-195).
17. See Shoup (1969b: 237-240).
18. For a good introduction to the tax, see Tait (1972). A useful treatment of the major issues may also be found in Shoup (1969a: 250-269).

Attention may be drawn to the following aspects:

1. The sum of all value added in the Table ($200) equals the consumer price, exclusive of tax. The tax base of a value-added tax is identical, therefore, to a tax levied on consumer prices, that is, a retail sales tax.

2. At each stage, the value added is determined by subtracting purchases from sales (subtraction method), but value added can also be computed by adding wages and capital income (addition method). In the EEC, the latter method was not chosen, because it involves difficulties in ascertaining border tax adjustments. Also, it may be surmised that politically the addition method would have been hard to sell.

3. The tax on capital goods may be credited immediately against the tax payable on sales. The total tax base of such a consumption type value-added tax is identical, therefore, to the total amount of consumer expenditures found in national income accounts. The tax on capital goods might also be credited in proportion to depreciation. The tax base of this net-income type value-added tax equals net national product. All countries, however, have chosen for the consumption type. This seems proper; after all, depreciation charges are already taken into account under income taxes.

4. The tax can be computed by applying the rate to the difference between sales and purchases (deduction technique), but the same result is obtained by allowing a deduction for the tax on purchases against the tax on sales (tax credit technique or invoice method). The EEC has chosen for the latter technique because vendors can then be required to state the tax on invoices, facilitating border tax adjustments and compliance control (cross-checking).

5. If the manufacturer in Table 3 would sell the typewriter directly to the retailer, he would pay $11 tax ($16 tax on the sales price less $5 credit with respect to purchases). Even if the wholesaler is left out of the chain, therefore, the consumer still pays $20 tax. In other words, the effective rate of tax does not depend on the number of stages that an article passes through before it reaches the consumer: the value-added tax is neutral with respect to the organization of production and distribution.[19]

6. If the typewriter had not been manufactured domestically, but purchased from a foreign factory, then the wholesaler would pay $15 tax at the border. At the time of purchase by the consumer, the total amount of tax would again equal $20. The value-added tax, therefore, does not discriminate in favor of or against imported goods: the tax is neutral between home-produced and foreign-made goods.

7. If the manufacturer decides to sell the typewriter abroad rather than domestically, he would not pay tax with respect to the value added by himself, and also receive a refund of $5 for the tax paid in previous stages. In fact, the typewriter is zero rated. It leaves the country free of tax and the importing country may apply its own rate of tax (destination principle). The tax is not exported.

8. If it is decided to impose a rate of 20% on the manufacturer, the mechanism of the tax implies that the wholesaler, whose sales are subject to 10% tax, can take full credit for the tax of $30 shown on the manufacturer's bill of sale. The wholesaler receives a refund of $14, therefore, and the total amount of value-added tax at the consumer stage is again $20. The same phenomenon, also called the "catch-up" effect of the tax, occurs if the manufacturer's sale would be subject to a lower rate of tax. Naturally, this effect does not occur at the retail level; only at this stage therefore, can differentiated rates be effectively applied.[20]

9. If retailers in typewriters were exempt from tax, that is, neither pay tax on sales nor receive a refund of tax on purchases, then the tax incorporated in the final product would be $16, or 8% of the final consumer price (excluding tax) instead of 10%. In contrast to the zero rate procedure, prior-stage tax is not refunded in case an exemption applies. Vis-à-vis other goods and services, exempt products receive favorable treatment. This avenue is adopted in the EEC for education, health, social, and financial services. The discrimination is small if the value added in exempt stages is small. On the other hand, the objective of the exemption is more fully achieved if the value added is large.

10. If, say, for technical reasons, it is decided to leave the iron founder out of the tax base, then the equal treatment of the typewriter vis-à-vis other goods may be approximately repaired by giving the manufacturer a presumptive tax credit of $2 for the tax invoiced to the founder but not creditable by him. This is the approach adopted with respect to the agricultural sector in the EEC. Of course, the method does not take account of individual differences in prior-stage tax burdens; only rough equalization is achieved.

B. The EEC situation

The Treaty of Rome establishing the EEC in 1957 recognized that the elimination of import duties would not be sufficient to create a common market if sales taxes and excises were allowed to function as trade barriers instead. In particular, the cumulative turnover taxes levied in all but one of the 6 original member states made it impossible to compute border tax adjustments unambiguously. Export rebates and compensating import taxes had to be estimated. Perforce, they could be used for protection purposes, a situation clearly inconsistent with the aim of creating a common market.

The EEC Commission was instructed, therefore, to consider how the various indirect tax systems could be harmonized. Both the Neumark and the Jansen Committees, set up to advise the Commission, recommended that the turnover-taxes should be replaced by a value-added tax of the type already in place in France and under active consideration in Germany (Neumark Com-

19. In contrast to the old cumulative turnover tax. If the rate of the latter had also been 10%, then the cascading effect would have raised the tax to 33% of the consumer price. Full integration of the production and distribution cycle would reduce the ratio of tax to consumer price to 10%.

20. Differential tax burdens can only be imposed prior to the retail stage if they take the form of excises, that is, if they cannot be credited against gross value-added tax liabilities. In the Netherlands this approach has been followed with respect to passenger cars.

mittee 1963; Jansen Committee 1963). The Council of Ministers of the EEC reached agreement in 1967; directives were issued specifying the deadline and the structure of the tax. By 1973 all member states, including the new entrants Denmark, Ireland, and the United Kingdom, had introduced the tax.[21]

A sixth directive, issued in 1977, established a uniform basis of assessment for the value-added tax through the adoption of common definitions for such important notions as taxable persons, taxable transactions, chargeable events, and taxable amounts. Near full agreement was also reached on the exemptions that are permitted. All member states exempt activities in the public interest, whether performed by private or public agents, such as hospital, medical and dental care; education, cultural activities, and postal services; and non-commercial radio and television broadcasts. All member states also exempt insurance, banking, and financial transactions, with the exception of the rental of safe deposit boxes, and the provision of advisory services. In addition, all member states, except the United Kingdom, exempt the sale of previously occupied residential property but tax the sale of new buildings. And finally, all member states treat governments as final consumer households, implying that military equipment, roads, bridges, and public buildings are also taxed. Special schemes are permitted for the treatment of small businesses and farmers.

Although the base of the value-added tax in the EEC has been almost completely harmonized, rates of tax still differ widely between member states, as shown in Table 4. The standard rate ranges from a low 10% in Luxembourg to a high 30% in Ireland. Furthermore, all member states, except Denmark, impose one or two reduced rates on items regarded as essential, such as agricultural and food products; pharmaceutical and medical goods; books and newspapers; and public transportation. Ireland, Italy, and the United Kingdom extend their reduced rates to a number of other items, including fabrics, clothing, and footwear; electricity and household fuel. In fact, in Ireland and the United Kingdom, these items are taxed at the zero rate, although early on it was agreed that the reduced rate should not be so low that prior-stage tax could not be deducted without a refund becoming due. Finally, three countries impose increased rates on items such as motor cars; audio-visual aids; jewelry and furs; perfumery and cosmetics; and various excisable goods. The coverage of the reduced rates comprises a sizable proportion of the sales tax base in the various member states (see Table 4).

In recent years, various countries have restricted the number of rates in order to reduce costs of administration and compliance. In its latest report, the EEC Commission (1980:54) suggests that member states should seek agreement on a dual rate structure comprising a reduced rate for agricultural and food products, and a standard rate for other products and all services. It argues that the level of the various national rates should be set within the limits of two ranges, i.e. 15-17% for the standard rate, and 3-5% for the reduced rate. Border tax adjustments on intra-community trade might be eliminated if rate structures were made uniform. Value-added taxes might then be levied on an origin basis, leaving manufacturing location decisions unaffected.[22]

Table 4
EEC: value-added tax rates and coverage, 1983
(in percent)

Country	*Statutory rates*			*Share of tax base*		
	Standard	Reduced	Increased	Standard	Reduced	Increased
Luxembourg	10	2 and 5	–	–	–	–
Germany	13	6.5	–	78	20	–
United Kingdom	15	0	–	60	40	–
Italy	18	2 and 10	20 and 38	–	–	–
Netherlands	18	4	–	71	29	–
France	18.6	5.5 and 7	33⅓	69	26	5
Belgium	19	6 and 17	25 and 33	61	32	7
Denmark	22	–	–	100	–	–
Ireland	30	0 and 18	–	–	–	–

Sources: Cnossen (1982a: 206) and Commission of the European Economic Communities (1980: 26).

C. Neutrality and administration

As a major source of revenue, the value-added tax is highly successful in all EEC member states; a little too successful perhaps. The value-added tax is a substantial improvement over its predecessors, the cumulative turnover taxes or the highly rate-differentiated wholesale and purchase taxes. Speaking for the Netherlands, with whose experience I am, for obvious reasons, most familiar, the transition from the old to the new sales tax took place with hardly a ripple.[23] Perhaps never before in the history of taxation has a major tax reform been undertaken so smoothly. The value-added tax is now widely accepted as a permanent fixture of the government's tax mix.

Infringements on the neutrality criterion are probably fewest under the value-added form of sales taxation. The usual distortion of production and distribution functions is absent, as are unintended deviations from tax to consumer spending ratios. Border tax adjustments can be made expeditiously and unambiguously.[24] Some cumulation of tax is inevitable in the case of exempt entities that are not permitted to invoice tax on goods sold that become inputs of taxable firms. In the case of large exempt sectors, such as education, health, and welfare, the taxation of intermediate and capital goods probably matters little anyway, because the sectors are heavily

21. Denmark had already introduced the tax in 1967, long before it became a member of the EEC. For an analysis of the experience with value-added taxation in Europe, see Aaron (1981). For a useful review, see also Carlson (1980).
22. This is the most widely held view in the professional literature. Although I believe that some alignment of rate coverage would be useful for administrative reasons, full equalization, in my opinion, is neither desirable, necessary, nor possible. It is not desirable, because national governments should retain as much discretion as possible in relying more or less heavily on the sales tax source of revenue. It is not necessary, because border controls can be done away with by shifting fiscal frontiers from borders to books of account. And it is not possible because the origin principle appears incompatible with the tax credit method of computing the value-added tax liability. For a full treatment, see Cnossen (1982b).
23. For a detailed analysis, see Cnossen (1981b).
24. The value-added tax, however, does not necessarily "increase the competitiveness of exporters", as the Australian Taxation Review Committee (1975: 519) believes. If it replaces a tax that is also neutral vis-à-vis the external sector, as is the wholesale tax, then theoretically there should be no change. If the tax that is replaced is not neutral, then compensating exchange rate movements would restore the previous situation, but differential effects might occur. Beneficial effects on exports, if any, might also be offset by a domestic wage/price spiral, although there is no evidence to support this hypothesis.

subsidized and prices controlled, that is, the incidence of the tax is indeterminate. Taxation is largely a bookkeeping exercise that does not make much sense, but may not do much harm either. This is also true with respect to the application of the tax to government fixed assets. The agricultural sector would be treated more evenly if farmers were taxed, with full credit for prior-stage tax. Here, as in the case of exemptions, feasibility considerations may be overriding in deciding to leave the situation as it is. That is certainly true with regard to the taxation of investment expenditures on new homes instead of rents and rental values.

The value-added tax involves more paper work, however, than any other form of sales tax. Nearly every business engaged in the production or trade of goods or the rendering of services must be registered.[25] Also, the tax administration must be able to handle a large number of refund claims for exports and for cases where credits exceed gross tax liabilities (reduced-rated commodities, for example). In the Netherlands, 1 out of 5 returns shows a negative tax liability; for every guilder collected, 25 cents must be refunded. Admittedly, this situation is unusual, because the Dutch export half of their GDP. Reportedly, some 6% of total receipts is siphoned off through tax evasion. Although better audit selection procedures and heavier penalties might reduce this figure, clearly the self-enforcing features of the value-added tax are not as evident as was once believed.[26]

D. The central technical lesson

Although it is difficult to get very excited about the unintended distortions of the value-added tax, because there are so few, the differentiated rate structures that exist in most countries are a major nuisance. Indeed, as Henry Aaron (1981:16) in his summary of the proceedings of a Brookings Conference on the subject says succinctly:

> The central technical lesson of European experience is that multiple rates can be used to eliminate the regressivity of the value-added tax, but that the penalties in administrative complexity, increased compliance costs, and distortions in consumption decisions have been high and probably unjustified.[27]

First the case against one or more reduced rates.[28] In most member states class-differentiated consumption patterns that are helpful in tax design for mitigating the regressive burden distribution of a broad-based sales tax have ceased to exist. Higher income groups often buy more expensive varieties of particular commodities, but price-related rate structures, indicated to achieve progressivity, cannot be administered properly. Also, the well-to-do spend proportionately more on education and holidays abroad, but such expenditures are exempt on merit grounds or cannot be reached. More importantly, the income tax and the social security system are more sensible and sensitive instruments to affect changes in the income distribution. For some items, e.g. public transportation, the application of a reduced rate makes little sense, because costs are subsidized and prices regulated. In other cases, such as recreational services that are usually taxed lower, the theory of optimal commodity taxation informs us that higher rather than reduced rates are indicated. Furthermore, the definitional refinements that are usually required to tax food products and medicaments lower give rise to numerous, casuistically natured disputes on interpretation that must often be settled before the courts. And, of course, retailers have serious difficulties in accounting for the tax consequences of differentiated rate structures. Generally, such structures accentuate the regressive burden distribution of compliance costs.[29]

Second, the case against increased rates is equally strong. Just as the reduced rate, they distort consumer choices and add to the costs of administration and compliance; in practice, coverage is narrow. With respect to motor cars, the most important "luxury" item, annual license taxes are much better tax handles to charge users. Audio-visual equipment, another major item, presents particularly difficult delineation and compliance control problems. Purchases can easily be made abroad; usually they would fall within the limits of the personal exemption. Cheap items and spare parts are difficult to exempt and must, therefore, be taxed along with expensive equipment. But this is inconsistent with the objective of the reduced rate. Heavier taxation of tobacco, as in France, or spirits, as in Belgium, can be equally well or better achieved through the excise system. The effect on revenue or progressivity of higher rates for jewelry, furs, perfume, and cosmetics is negligible; they are truly nuisance levies. In summary, the single most important technical flaw of the EEC value-added taxes is their differentiated rate structure.

IV. RETAIL SALES TAXES

The last broad-based sales tax that merits attention is the retail sales tax. When the EEC was considering various forms of sales taxation to achieve uniformity in border tax adjustments, the alternative of a retail tax was rejected, because "it will not be feasible to impose as the sole form of the (sales) tax a single tax at the retail stage, due to the practical reasons of fiscal technicalities (particularly considering the very large number of small retail merchants, most of whom are unable to keep exact books)" (Neumark Committee 1963:47, 49). Moreover, in recommending the value-added tax, it was suggested that the tax should extend through the wholesale stage only. Yet, surprisingly, all member states covered retailers from the date they introduced the value-added tax, and there have been no serious complaints from merchants or tax administrators.

25. As opposed to what the Taxation Review Committee (1975: 519) appears to imply, I do not believe that the larger number of taxpayers is really the "chief disadvantage" of a value-added tax in a country like Australia with a high degree of voluntary compliance and very sophisticated tax machinery. Moreover, on the basis of a U.K. study, Carlson (1980: 77) points out that a retail tax would involve only about 25% fewer taxpayers, because manufacturers and wholesalers that sell directly to consumers must also be registered.

26. Also instructive is the Irish experience, as reported by Due (1977: 200-223).

27. For evidence that the regressivity of the European value-added taxes is mitigated to some extent, see Adams (1980); Organization for Economic Cooperation and Development (1981); and Cnossen (1981b: 240-242).

28. For a detailed exposition of the following arguments, see Cnossen (1982a).

29. For a U.K. study on the distributional aspects of compliance costs, see Sandford et al. (1981).

Some of the early European apprehension about the feasibility of a retail tax is also voiced by the Australian Taxation Review Committee. It believes that (1975:517):

> a tax confined to the retail level raises administrative and compliance problems not found when a tax operates only at an earlier stage: the number of taxpayers increases and small traders unused to making returns are required to do so. . . . The system is open to evasion: the licensed buyer would be able to apply to private consumption goods bought free of tax as though for business use or resale. The temptation to evasion grows as the tax rate increases. . . .[30]

In my view, the experience with retail taxation in the United States and Canada does not corroborate these misgivings. The tax has been a successful source of revenue in these countries, and administrative and compliance problems have certainly not been any greater than under the value-added tax, given similar levels of tax administration. This section examines developments in the United States, Canada, and Switzerland. First, there is a sketch of the history and basic features of the taxes. This is followed by a review and evaluation of various structural aspects: the treatment of producer goods and interstate sales, and the coverage of consumer goods. Also, administrative experience is briefly summarized.

A. History and basic features

The development of modern retail taxes owes much to their successful application in 45 out of 50 U.S. states.[31] Often introduced as desperation measures in the 1930s to raise more revenue than was possible with the low-rate business occupation taxes levied until that time, over the years the tax became a major source of revenue, on average accounting for some 30% of states' revenues. Not surprisingly, because of its high visibility, initially the tax was greatly resented by the business community. Within a few years after being introduced, however, it became a widely accepted form of taxation that is still being improved in terms of coverage and administration. The only major problem relates to interstate sales; a satisfactory solution is difficult to devise due to the peculiarities of the U.S. Constitution.

Structurally, the provincial retail taxes in Canada closely resemble those in the U.S., although their coverage is somewhat more restricted. Most Canadian taxes were introduced after the second world war, primarily to finance expanded social, health, and educational programs. In fact, the name of the tax often designates the program to which receipts are applied, thereby promoting the acceptance of the tax. Nine out of 10 provinces now have a retail sales tax. Switzerland levies the tax at the national level. Introduced in 1941 to finance increased defense expenditures, initially the tax was largely collected at the wholesale stage with a lower rate applying to direct sales to consumers. Over the years, however, the point of impact has gradually moved forward and four fifths of receipts are now collected from sales made at retail.

Table 5 presents the basic features of the various retail taxes. Typically, rates are lower than those of other sales taxes. The average rates in U.S. states and Canadian provinces are 4-5% and 7-8%, respectively, whereas rates of value-added taxes in EEC countries are 2 to 3 times higher. Fewer attempts are made to exempt capital goods systematically from tax; Switzerland taxes most of them. Problems arise when the taxing jurisdiction where goods are sold as well as the jurisdiction where they are

Table 5
Scope of retail taxes in the United States, Canada, and Switzerland, 1983

	U.S. states	*Canadian provinces*	*Switzerland*
Years of introduction	1932-1969	1948-1967	1941
Level of government	45 out of 50 States[a]	9 out of 10 Provinces[b]	National
Range of rates (median)	2-8 (5)[c]	5-11 (8)	6.2/9.3[d]
Treatment of producer goods			
Raw materials, intermediate goods	Exempt under physical ingredient rule	Exempt under physical ingredient rule	Exempt under license
Fuel, power, consumables	Exempt in about half of all States	Generally not taxed	Not taxed
Industrial machinery	Exempt in 28 states[e]	Taxed in 8 provinces	Taxed at 6.2%
Agricultural equipment	Exempt in 22 states[f]	Mostly exempt	Taxed at 6.2%
Transport vehicles	Taxable	Taxable	Taxed at 6.2%
Building materials	Taxable	Taxable	Taxed at 4.65%[g]
Treatment of interstate sales	Out of state sales not taxable but use taxes applied instead	In theory taxable twice; in practice origin rate applies	Not an issue
Coverage of services	Not taxed in 42 states[h]	Not taxed in 8 provinces[i]	Not taxed
Exemption of essentials			
Food products	27 states[j]	All provinces	Exempt
Medication	39 states[k]	All provinces	Exempt
Water, fuel, electricity	Several states	Div. treatment	Exempt
Soft drinks, candy	Taxable	Taxable	Taxable
Clothing, footwear	5 states	Most provinces[l]	Taxable
Furnishings, appliances	Taxable	Taxable	Taxable
Taxation of luxury items	No higher rates	No higher rates[m]	No higer rates

Sources: U.S. states and Canadian provinces - Due (1957: chapters IX, XIII, XIV; 1970: chapter 5; 1983). Also Cnossen (1975: Table 1).

a. Exceptions are Alaska, Delaware, Montana, New Hampshire, and Oregon.
b. Alberta introduced a sales tax in 1936, but repealed the tax one year later without ever reinstating it.
c. Including local sales tax rates of 1/4-4%; the most common rate is 1%.
d. The rate of 9.3% applies to wholesalers selling at retail.
e. Including one state in which the exemption is being phased in; in 5 states the exemption applies to new and expanding industry only. In addition, 4 states levy a reduced rate.
f. Including 2 states in which the exemption is being phased in. In addition, 7 states levy a reduced rate.
g. Applies to property contract work.
h. Except hotel, motel, and restaurant services, and admissions. Also, some states tax repair and dry cleaning.
i. Four provinces tax some services.
j. Including one state in which the exemption is being phased in. In addition, 2 states levy a reduced rate.
k. In addition, one state applies a reduced rate.
l. Except children's clothing which is exempt in all provinces except two.
m. Except a 10% rate on meals and liquor in Ontario.

30. It may be noted, however, that the frequency with which licensed buyers act as consumption units is much smaller than, for instance, the number of times manufacturers and wholesalers act as retailers under a wholesale tax.
31. And, it should be added, the record and analysis of the retail taxes owes nearly everything to John F. Due. For concise and succint treatments, see Due (1983); (1970: chapter 5); and (1957: chapters IX, XIII and XIV). This section draws heavily on these publications.

used or consumed establish a claim to tax. In contrast to the EEC value-added tax, only sales of tangible personal property are subject to tax; services are not covered. Real property work is taxed only in Switzerland, albeit at a reduced rate. Furthermore, most governments exempt food products and medication under their retail taxes but tax almost all other consumer items. No retail tax applies a higher rate to goods regarded as luxuries.

Inherently, the actual selling price is nearly always the value for tax. Discount and uplift systems of adjustment, as under wholesale taxes, are not necessary. Non-arm's length transactions occur rarely, generally being confined to the application of the tax to goods produced for the firm's own use, or to goods withdrawn from stock for personal use. Delimitation issues do arise, however, when goods and services are rendered in combination. The tax is levied on an accrual rather than a receipts basis; hence, sales on credit are taxable immediately. Incidental delivery and financing charges are usually excluded from the taxable price if billed separately. Technically, sales at retail may be made by wholesalers, manufacturers, as well as retailers when engaged in the business of selling. In most taxing jurisdictions, therefore, these establishments must all be registered. Even if they do not make any sales at retail, registration facilitates the exclusion of their purchases from tax. This implies that the number of registered taxpayers under a retail tax should not be much smaller than under a value-added tax.[32]

B. Producer goods and interstate sales

United States and Canadian retail taxes define taxable sales as sales for use or consumption, and not for resale. Under the physical ingredient rule, sales for resale, in turn, are defined to include the purchase of goods for use as materials or parts (including feed, seed, and fertilizer) in other goods being produced by the firm.[33] The result is that raw materials and intermediate goods are universally exempt from tax. Similarly, industrial fuels are generally not taxed. This leaves capital goods, such as industrial and agricultural machinery and equipment, for which explicit exemptions must be formulated, if it is desired to avoid cumulation of tax. A substantial number continues to be taxed, as evidenced by collection records which show that some 20% of tax receipts derives from sales of capital goods.[34]

The practice of taxing capital goods may be rooted in the history of the retail taxes that grew out of widely applied business occupation taxes. Also, in early days, the "equity" notion that every business should pay the tax was probably more widespread. Policy makers were less aware of the detrimental effects of taxing capital goods. Furthermore, revenue considerations may have played a role, as well as the argument that harmful effects were limited because the rate was low. And administratively there was the presumed inability of vendors to distinguish taxable and exempt sales of goods that could be used for consumption as well as production purposes, and the lack of enough qualified auditors to verify books of account.

Of course, there is no good argument for taxing capital goods. Businesses are induced to make different and, from a social point of view, inferior choices with respect to inputs. Factor combinations are altered and exports are burdened unevenly. Fortunately, the trend in the United States, but apparently not yet in Canada, is to expand the exclusion of capital goods. In fact, 4 states already do so as widely as the EEC value-added tax, apparently without experiencing insurmountable administrative difficulties. In Switzerland, the Assembly has instructed the government to consider ways of modifying the tax in order to exclude capital goods.

Another non-neutral element and source of tax evasion is the treatment of interstate sales. Barred by the U.S. Constitution from levying tax on out-of-state purchases, states have taken recourse to use taxes imposed on the first use of goods bought outside the state. These taxes are quite feasible, of course, with respect to goods, like automobiles, that must be registered anyway or goods purchased by registered businesses, but not with respect to other commodities. Generally, mail order firms cooperate with destination states in levying the tax, but it is not possible to charge other out-of-state purchases to tax.

C. Coverage of consumer items and administration

The exclusion of services under retail taxes distorts consumer preferences and producer choices; it is also a major source of administrative complexity. Arbitrary rules must be devised to separate the service element from the sale of a good whenever the two are rendered in combination. Generally, practice is to exempt the margin on materials when the service element is dominant (usually the purchaser, e.g. a barber shop, would then not be registered); to tax the service element when the value of the combined activity comprises mainly materials (e.g. printing and photography work); and to separate the two when the elements are about equal in value (e.g. repair of personal property). The delimitation of taxable from non-taxable elements is as great a nuisance as the distinction between retail and wholesale functions under a wholesale tax. It severely complicates compliance as well as audit work. A special bone of contention is the treatment of real property contractors who are encouraged to manufacture installations on-site (exempt) rather than having them prefabricated (taxable).[35]

Another source of administrative complexity is the exemption of food, medication, and some other consumer items. Although understandable at the time the retail taxes were introduced (after all, instruments to alleviate regressivity were much fewer), such exemptions are very difficult to justify in countries with modern income taxes and social security systems. Here, the same arguments apply as those voiced above with respect to the differentiated rate structures of the value-added taxes in the EEC. Some U.S. states have found a workable solution to the problem by taxing food products

32. See footnote 25.
33. Due (1957: 296-297).
34. Due (1957: 299).
35. See the description in Due (1957: 279-280, 297-298).

across-the board, but permitting low-income taxpayers a non-wasteable credit for the sales tax paid on food purchases against their income tax liability. The exemption of (prescription) medication is somewhat easier to justify, because expenditures are unevenly distributed across income brackets. Some states or provinces exempt clothing, even though there is evidence that the exemption is regressive with respect to income.[36]

Finally, there is the small-firm issue. In Switzerland, such firms are not permitted to register, but a higher rate applies to their purchases. But this approach requires that they have to be identified as retailers and not as consumers. In Finland, small retailers are taxed only on value added, that is, they are permitted to deduct the tax on purchases from the tax on sales. No exemption exists in the United States and Canada, and this is probably the most sensible approach. With increasingly larger retail outlets and commercial integration few sales at retail take place outside established channels. Virtually all retailers buy their supplies from wholesalers and manufacturers rather than from farmers and small artisan producers. Small merchants who are not registered usually buy their goods from registered retailers; thus, little tax escapes. On the whole, compliance control is satisfactory. Books of account of retailers are easier to examine than those of manufacturers. Coordination with income tax audits helps. No doubt some evasion takes place, but on the other hand avoidance is rare.

In his most recent assessment of retail taxes, John F. Due (1983:238-239), concludes that the general experience has been highly successful in the United States and Canada. The extent of evasion is small, provided retailing is a truly commercial activity and an effective audit and enforcement program is employed. Some problems require vigilance, including "hit-and-run" retail vendors, filing delinquency, and issues of interpretation, but these have never reached unmanageable proportions in any North American sales tax jurisdiction. As under the value-added tax, the central lesson is that exemptions of essential goods and the exclusion of services are unjustified.

V. CONCLUDING REMARKS

This section summarizes the pros and cons of the three forms of sales taxation discussed above. In my opinion, the wholesale tax should be rejected. Countries having this tax might be advised to consider a value-added tax or a retail tax. On purely theoretical or technical grounds, the choice is largely a stand-off. Whether one or the other sales tax is adopted, it is extremely important that the base be as broad as possible and that a uniform rate be adopted. Exemptions should be minimized and rate differentiations should not be introduced.

A. Pros and cons of various sales taxes

In terms of the broad criteria used throughout the paper: elimination or mitigation of potential competitive distortions and identicalness of statutory and effective tax rates – the wholesale sales tax may be the second-best thing to a retail sales tax or a value-added tax, but its shortcomings are still too obvious to ignore. Because retail margins are not included in taxable value, uniformity in effective tax rates will not be achieved. Moreover, a strong incentive remains to integrate retail activities backward.

Sales by wholesalers directly to consumers require complex adjustment procedures that may roughly equalize competitive conditions within a particular industry, but need not ensure neutrality between industries. Valuation problems under a wholesale tax can be partially solved by inducing the tax collection mechanism to move forward to the retail stage, as is done in Switzerland, but this raises the question whether the Government should not go all the way to the retail stage. At the time the Swiss introduced their sales tax in 1941, this may not have been feasible, but since then retail outlets have become much larger and better administered. Furthermore, as experience elsewhere shows, attempts to include outward transportation costs in taxable value are highly controversial and usually break down in implementation. Also, dual firms are a nuisance under a wholesale tax.

The choice between a retail sales tax and a value-added tax of the consumption type (with an immediate credit for the tax paid on capital goods), levied using the credit (invoice) method of computation, is largely a stand-off.[37] Both taxes are very similar in terms of economic effects. Both achieve an almost complete degree of neutrality between forms of economic organization and the treatment of domestic goods versus imports. Freeing producer goods from tax may be slightly more difficult under a retail tax. Services can be taxed somewhat more easily under a value-added tax with less threat of cumulative effects with respect to services rendered to business establishments. In terms of mitigating the regressive tax burden distribution, exemptions and rate differentiations are about equally difficult to administer under both forms of sales taxation.

Differences in administrative feasibility are also minimal. There would be more taxpayers under a value-added tax and the volume of paperwork would be greater, but this disadvantage does not carry much weight in countries like Australia, Canada and New Zealand with a high degree of voluntary compliance and sophisticated tax machinery. The potential for cross-checking under a value-added tax is a plus that should make it easier to control compliance. A retail sales tax may be somewhat simpler in concept, but the difference is marginal. In addition to accounts receivable, track has to be kept of accounts payable, but any other accounting is unneccessary under a value-added tax. With proper taxpayer education, a changeover to a value-added tax can be handled without great difficulty as evidenced by European experience. A major attraction of the value-added tax is that the tax collection process is spread out over the whole production-distribution chain, whereas the impact of a retail sales tax falls fully on one class of taxpayers. Under a value-added tax, therefore, evasion may be more difficult, or at least less likely to succeed for the full amount of the tax.

36. As shown by Schaefer (1966: 596-599).
37. For a detailed comparative treatment of the value-added and retail forms of sales taxation, see Shoup (1973).

B. A personal view

The arguments developed in this paper lead me to conclude that the option of extending the base of existing wholesale taxes should be rejected. Politically, it will probably be extremely difficult to broaden the coverage of the tax. As with other taxes, preferential treatment once extended is nearly always impossible to retract. Differences in established interests of consumers and producers are difficult to reconcile through partial or piecemeal measures. A sure way of not having any meaningful sales tax reform is to hammer away at the anvil of the wholesale tax.

In my opinion, only something new and different can lead to useful sales tax reform, that is, the adoption of a broad-based, revenue-elastic tax that distorts resource allocation as little as possible. That has to be a value-added tax of the EEC type or a retail tax of the type found in North America, but inclusive of services. As this paper shows, both taxes have proven to be efficient and workable instruments of taxation. Whichever tax is chosen, it is important to emphasize that a broad base and a single, uniform rate are highly desirable. Exemptions and differentiated rate structures inevitably discriminate on the basis of relative preferences. Their effect in mitigating a regressive tax pattern is minimal. Discriminatory treatment involves deadweight losses for businesses that are difficult to shift forward into prices. Tax administration and compliance are greatly complicated.

Although in theory there may be little to choose from between a value-added tax and a retail tax, if asked for advice, I would favor a retail tax. My arguments turn largely on the workings of the political process. Basically, I am apprehensive about the revenue potential of a value-added tax. In the EEC the tax has proven an easy means of increasing the role and scope of government activities. There is evidence that more than twice as much revenue can be collected under a value-added tax than under a retail tax, without running into major taxpayer opposition. Apparently, on account of the multipoint collection feature of the value-added tax, a higher rate of tax encounters less resistance. I believe that this is a disadvantage. A retail tax appears more conducive to promoting tax consciousness, regardless of academic notions about identicalness of incidence. Placing the full tax on consumer purchases and insisting on separate quotation may heighten awareness of what government costs. In taxation as in other fields, the medium appears to be the message.

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The Comparatively Limited Role of Income Taxation in Developing Countries

by Sylvain R.F. Plasschaert

In this paper, we look at and interpret data about the relative importance of income taxation in developing countries (LDCs), as compared to industrialized or developed ones (DCs). Much valuable research has already been devoted to the explanation and the empirical testing of the typically lower "(overall) tax ratio" in low-income countries, as against industrial ones. The role of income taxation has been less systematically covered. We shall attempt to cover that gap, by way of discussing various interrelated determinants of the structurally weak role of income taxation in LDCs.

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I. THE FACTS

The distinctly lower significance of income taxation in developing countries is illustrated in Tables 1 and 2, which contrast 23 OECD member states with 63 developing countries. In each of these two groups, countries are ranked in descending order of their overall tax ratio and subdivided into three categories, of which the "highest" and the "lowest" comprise an equal number of countries.

TABLE 1
Overall and income tax ratios 1972-76
(unweighted arithmetic means; as % of GDP)

	OECD countries				*Less developed countries*			
	Ranked per overall tax ratio							
	highest 5	*middle 13*	*lowest 5*	*all*	*highest 15*	*middle 32*	*lowest 15*	*all*
All taxes	44.46	33.57	22.15	33.02	25.70	15.39	8.79	16.03
of which:								
Income and profit taxes	19.99	13.10	6.04	13.06	9.62	3.76	1.95	4.73
Property taxes	1.60	2.31	1.56	1.99	0.33	0.24	0.22	0.26
Taxes on goods and services	12.95	10.30	7.79	10.33	13.72	9.90	5.76	9.82
Social security contributions	9.25	7.25	6.12	7.44	0.87	0.50	0.14	0.50
Other taxes	0.63	0.62	0.64	0.63	1.15	0.99	0.73	0.97

Source: R. Goode, "Limits to Taxation", *Finance and Development*, March 1980, p. 13.

The tax ratio

According to Table 1, the overall tax ratio for the OECD group, on the (non-weighted) average, is more than double that achieved by the LDCs. One notices, however, that the implicit rank correlation between tax ratios and per capita incomes is rather weak. Thus, the lowest OECD category attains a lower tax ratio than the higher range of LDCs. This comes as no surprise, as the subgroups are by no means homogeneous: thus, Turkey, while definitely not a rich country, is a member of the OECD. Besides, the distinction between industrial and developing countries, while useful for analytical purposes, is no longer a polar one in the real world. Fortunately, a number of LDCs have moved upwards to intermediate levels of per capita income and are increasingly being categorized as such in international statistics.[1] In other words, the underdeveloped world is not solely made up of countries bunched at the bottom. And such differences within the Third World are also relevant for tax purposes.[2]

Table 1 also suggests that the per capita income level may be an important determinant of actual tax ratios, but should not be viewed as the sole factor. Otherwise, as we move up the ladder of per capita income, the countries listed would also exhibit a neatly growing tax ratio.

The income tax ratio

Table 1 shows that, on average, not only the overall tax system but also the income tax (including taxes on net corporate profits) claims a lower share of GDP in the underdeveloped than it does in the developed world. For these two groups the average income tax ratio stands at respectively 4.73% and 13.06%. Here again, the income tax ratio of the category of LDCs with a higher overall tax ratio exceeds that of the lowest segment of OECD countries.

Incidentally, when we compare the gap in the overall tax ratio and in the income tax ratio between developed and developing countries, a rather interesting question emerges. Under the plausible assumption that divergent actual tax ratios also reflect objective differences in the ability of governments to mobilize revenue, we may specifically ask ourselves to what extent the lower (overall) tax ratio of poor countries could be related to less

1. The World Bank Statistics, as contained, for example, in the (annual) World Development Report, nowadays contain various subsets of LDCs.
2. For a recent endeavor to account for the tax characteristics of a subgroup of LDCs, see Tanzi, V., "Tax Policy in Middle Income Countries: Some Lessons of Experience", paper delivered at a conference in Santiago, Chile, IMF, DM/81/62, 1981.

favorable opportunities for the implementation of income taxation. We turn to this issue at a later stage of this paper.

The relative share of income taxation

Table 2 tabulates the relative contribution of income taxation to overall tax revenue. In general, income taxes perform a typically more limited role as a source of revenue in underdeveloped (27.03%) than in developed countries (37.98%). In fact, this finding is already implicit in Table 1, from which the relative contribution of income taxation to overall revenue can be derived; thereto, one must only divide the income tax ratio by the overall tax ratio. In other words, if in all countries covered the income tax were to contribute the same proportion of overall government revenue, the overall tax ratio, by definition, would yield the same multiple of the income tax ratio. Differences in the aggregate tax ratio would then have to be related to differences in the revenue significance of the taxes other than those on income. The above assumption, obviously, is not realistic.

TABLE 2
Composition of overall tax revenues 1972-76
(unweighted arithmetic means; in percent)

	OECD countries				*Less developed countries*			
	Ranked per overall tax ratio							
	highest 5	*middle 13*	*lowest 5*	*all*	*highest 15*	*middle 32*	*lowest 15*	*all*
All taxes	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
of which:								
Income taxes	44.93	39.60	27.57	37.98	37.43	24.43	22.18	27.03
Property taxes	3.67	7.16	7.05	6.38	1.28	1.56	1.59	1.50
Taxes on goods and services	29.06	30.48	34.45	31.03	53.39	64.33	65.53	61.97
Social security contributions	20.95	21.02	27.96	22.51	3.39	3.25	1.59	2.88
Other taxes	1.38	1.74	2.97	1.93	4.47	6.43	8.30	6.42

Source: R. Goode, "Limits to Taxation", *Finance and Development*, March 1980, p. 13.

II. DETERMINANTS OF OVERALL TAX RATIOS AND OF TAX EFFORT INDICES

That the (overall) tax ratio tends to be considerably lower in low-income than in high-income countries is an intuitively attractive position. As already mentioned, income may be hypothesized prima facie as an overriding determinant of the capacity of countries to bear taxes. The widely-used although vague concept of (macro-) taxable capacity denotes the degree to which a given society can be subjected to tax burdens without suffering unacceptable economic and political consequences. Thus, it carries the connotation of a ceiling which should not be exceeded. Obviously, a given tax ratio will involve more sacrifice and loss of utility by the taxpayers in a poor than a rich country. In this context, one may refer to the so-called sacrifice theories which have traditionally been cited in support of progressive taxation. Despite their intellectual shortcomings, those theories attempt to rationalize the ethically appealing thesis that the rich man is better able to pay taxes. An analogous argument can be contrived as regards the relative capacity of nations to bear taxes.

In a more general sense, one must recall that taxes levied on a given base – whether consumption, property, exports or income – must be paid by taxpayers out of their income or out of converting assets held into money, i.e. by drawing down property. This consideration, in itself, already suggests, prima facie, that marked differences in per capita income levels account to a large extent for differential taxable capacity among countries. It follows that the impact of per capita income levels on the country's (macro-) ability to pay taxes does not depend uniquely upon the capacity to harness resources out of income taxation proper.

Empirical test for the tax ratio concept

From the early 1960s onwards a number of attempts have been made to test empirically the relevance of various conceivable determinants of the tax ratio, and, in a later stage, of the tax effort of countries. The latter concept indicates to what extent the tax ratio of a given country exceeds or falls short of "taxable capacity" or, in the words of R. Bahl, the "tax ratio that would result if a country applied to its tax bases a set of 'average' effective rates on those bases",[3] the averages being derived precisely from the regression analysis of actual tax ratios. Those analyses have been mainly conducted by the Fiscal Affairs Department of the IMF.

A few variables have emerged as having strong explanatory power. Per capita income differentials explain a substantial portion of the variance in the tax ratio between high-income and low-income countries, but fail to account for much of the variance of only the groups of LDCs (say, below the $800 level, at the end of the 1960s). Besides, differences in the openness of the economy (measured by exports, imports, or both, relative to GDP) explain part of the differential tax ratios between LDCs. The share of the mineral sector in overall output has also been identified as a relevant explanatory variable with a positive impact on taxable capacity, whereas the agricultural sector tends to have a negative effect on the capacity to implement taxes.

These findings come as no surprise. While per capita income levels, usually, but not always (as exemplified by some OPEC countries which were recently catapulted to the top ranks of the per capita income league, while their economies and societies have not yet become fully developed), are a convenient proxy for different stages of development, it would be unrealistic to expect that taxable capacity is linearly related only to per capita levels. Other variables are at work. A higher foreign trade ratio can easily be rationalized as a factor which enhances the achievable tax ratio. Import and possibly export trade can be checked at a few harbors; and foreign trade intermediaries are most often operating as modern firms with a high degree of visibility. These remarks apply especially to mineral exports.

3. Bahl, R.W., "A Regression Approach to Tax Effort and Tax Ratio Analysis", *IMF Staff Pappers*, p. 572.

The authors of the econometric studies discussed here warn themselves that the findings must be interpreted with caution, for several reasons. A number of criticisms have been levelled against those regression analyses in the specialized literature.[4] Thus, the exercises have been plagued by statistical problems such as the interrelatedness between the explanatory variables, i.e. by multicollinearity. For some plausible explanatory variables, such as the extent of subsistence agriculture or the interpersonal distribution of income, available data are utterly inadequate. But some conceptual deficiencies have also been objected to. The "average" of actual tax ratios, which functions as the norm for the tax effort rankings, may not fully reflect all available taxable capacity, part of which may remain untapped; in other words, inferences from positive economics should not be mistaken as predicaments of normative economies. And the econometric studies do not adequately capture the link of tax policies with societal preferences (revealed in more or less democratic societies or decreed by a dictator or an oligarchy). The trade-off between private and public expenditures, for example, is bound to entail differences in the actual tax ratios in countries with similar income levels and economic characteristics. Finally, the neat figures generated by this quantitative research may provide an excuse for their misuse in the political arena: hence, whatever broad insights the resulting indices of tax effort may yield must be carefully complemented with considerations which pertain specifically to a given individual country.

III. DETERMINANTS OF THE INCOME TAX RATIO

In this section, we look for variables which are capable of explaining why the income tax ratio in LDCs lies typically below that in DCs; or, in somewhat different terms, why the available taxable capacity tends to be tapped comparatively more through tax handles other than the income tax. The approach runs in non-econometric terms; anyhow, tests on most of the explanatory factors that are suggested would be precluded by lack of data. I propose to tackle this topic first by specifying the characteristics and requirements of a modern system of income taxation and, subsequently, by examining under which restrictive assumptions the income tax system could be visualized as providing an equivalent or larger share of fiscal revenue in LDCs, as compared to developed ones. But we must first express a warning about some facets of the data collected on income taxation which involve the risk of gross misinterpretations.

The most important one is that the studies which scrutinize tax ratios and their determinants usually lump both the revenue from taxes on (a) net income of individuals and on (b) profits of corporations together under the single heading of "income taxation". But separation of these two components of income taxation would be helpful. It would be misleading to infer that two countries which display the same overall tax ratio are similar if in country A revenue flows largely from individual income taxation whereas in country B the bulk of the income tax revenue is provided by a few major mineral ventures. Nowadays, a number of OPEC countries qualify as examples of the last category even though the appropriation of the mineral rent occurs through such devices as royalty payments, which differ from corporation tax proper. The distinction between the personal and corporate areas – or, more broadly, business profits – of income taxation would reduce the risk for superficial comparisons.

Yet the data, even when thus disaggregated, must be used with care, as both economic and design factors complicate their proper interpretation. In most countries, the same legal category (of incorporated firms) encompasses a majority of small, family-type ventures and a few large companies. The latter, nonetheless, represent the lion's share of corporate turnover; the shares tend to be widely held; such firms are directed by professional managers who may hold no shares whatsoever in the company which employs them. This dichotomy of economic substance within the same legal cloth creates stubborn problems for tax policy makers, as discussed in another paper.[5]

The collection and interpretation of statistical data on income taxation faces another hurdle which directly relates to the subject matter of a wider study, of which the present paper forms part.[6] In global-type income taxes, impersonal, flat-rate corporation taxes typically exist alongside individual income taxes that are equipped with a set of progressive rates. But consistently designed schedular tax systems do not provide for the separate treatment of corporate bodies; they subject profits of any business unit, irrespective of the legal form, to the same schedular tax. This uniform statute conceals, even more than in a global system, economically meaningful differences amongst business units. As a matter of fact, in the tax on "enterprise" profits which is part of a consistent schedular system, not only the "incorporated family-type" unit but also the "unincorporated single proprietorship" – most often a tiny unit – is treated for tax purposes in the same manner as the large, widely-held corporation.

IMF compilation is a significant step forward

Since 1978, the International Monetary Fund has published the *Government Finance Statistical Yearbook* in which, on the revenue side, tax categories are comprehensively canvassed within a standardized framework. Income taxes on individuals and on corporations are separately shown. This takes proper care of the large majority of countries, in which income taxation is of the global type. Such an approach implies, however, that in countries with schedular systems (and hence with taxes on the net profits of all business units), it would be necessary to distinguish, within the "enterprise tax" schedule, the subset of corporations proper and the non-corporate entities.

4. See Prest, A.R., "The Taxable Capacity of a Country", in, Toye, J.D. (ed.), *Taxation and Economic Development* (Frank Cass, London, 1978); and, Bird, R.M., "Assessing Tax Performance in Developing Countries: A Critical Review of the Literature", in *Finanzarchiv*, 1975, pp. 639-82.
5. Plasschaert, S., "The Treatment of Enterprise Profits in Schedular and Global Frameworks of Income Taxation", in 35 *Bulletin for International Fiscal Documentation* (1981), pp. 261-71.
6. Plasschaert, S., "Schedular, Global and Mixed Types of Income Taxation with Particular Reference to Developing Countries" (in progress).

The present state of statistical information renders this approach rather impracticable. The Fund adopted an alternative procedure: "where schedular income taxes are levied on various kinds of income, such as rents, royalties, dividend and interest, and the tax administration does not distinguish between corporate and individual taxpayers, each tax should be reported under 'other' (unallocable income tax)."[7] Anyhow, the IMF compilation amounts to a significant step forward towards international cross-section data on the various branches of national revenue systems.

One should also mention that given types of tax may, to some extent, function as a substitute for taxes on income. In a large number of LDCs, the agricultural sector is taxed, if at all, through property taxes on land holdings rather than through taxes on profits from agricultural activities. Especially when property values are assessed by way of capitalizing the presumptive returns from land, the land tax can be viewed as a "first cousin" of the income tax proper.

A similar remark applies to those LDCs in which export taxes on raw materials (mineral or agricultural) function as a substitute for income taxation. In this way, small farming units can be reached more easily, albeit indirectly, than if the net profits were to be directly assessed. The two tax handles, however, are basically different. Contrary to net income and profit taxes, export duties are based on the gross value of the exported commodities.

The data in Table 2 clearly show that income taxes provide a less significant tax handle in LDCs than in DCs. This is particularly true with respect to individual income taxation; as already stressed, a high level of company taxation, or even, in schedular systems, a tax on enterprise profits, may be due to one or a few mineral ventures; while taxable capacity is thereby enhanced, the country itself may still hover at a low level of development.

Limited role of income taxation in LDCs

So far, so good for the factual data. We should move towards explaining the comparatively more limited role of income taxation in LDCs. A first question is whether there is, a priori, a commanding reason why, even if the total tax take in a poor country is lower than that in a rich country, income taxation, of necessity, yields a lower share of overall revenue than in developed economies. The answer is negative, but the retrictive underlying assumptions must be considerably relaxed in the circumstances of the real fiscal world.

One can theoretically envisage conditions, indeed, in which the share of income taxation in overall revenue would perform better in LDCs than in DCs. Let us abstract from the possibly specific impact which a large mineral export sector may have on taxable capacity – although such an occurrence would rather strengthen the case contrived here, which rests on the following set of hypotheses:

(a) Personal income in country Poor is more unequally distributed than in country Rich. For example, the highest two deciles of taxpayers derive, respectively, 65% and 50% of overall income.[8]
(b) The reach of individual income taxation is restricted to the upper income strata. Only, say, those two upper deciles are subjected to income taxation. In other words, the income tax would be a tax on the upper class, i.e. on the financial elite, not on the masses.
(c) In countries Poor and Rich, a similar average tax rate is applied on thos subjected to income taxation. If, for example, a 40% average rate obtains, in country Poor the income tax would yield 26% of, say, personal income, but only 20% in country Rich.

Each of these underlying assumptions must be verified. Condition (a), seemingly, corresponds to the actual state of income distribution in LDCs – although there are many deviations and the statistical data are very often of poor quality.[9]

Income distribution statistics, however, have an ordinal, or relative, dimension. They do not convey information on absolute levels of income. Someone who in country Poor is located at the 80% percentile level of the income distribution pyramid (in upward perspective) is obviously relatively much better off than the slum dweller who forms part of the lowest decile; but the bundle of goods and services which his income commands is likely to be more modest than what somebody in the lower middle class in country Rich is able to reach. Notice that the term "middle class" as used in high-income countries denotes not only an intermediary rank, but also connotes that the income level of the recipient exceeds that of deprivation or of absolute poverty.[10]

Governments enjoy a degree of discretion as regards the reach of income taxation; they could restrict its application to the (ordinally) upper-class citizens, or to given types of incomes – if revenue needs could be covered through other means. But in DCs, the income tax has become a mass tax, extending its grasp beyond the upper crest to the broad spectrum of what is called the middle classes. As abundantly documented by F. Neumark,[11] this escalation of the reach of income taxation occurred during World War II, when public expenditures were irreversibly placed on a much higher level. Only this broadening of the perimeter of the income tax to large groups of taxpayers enabled the income tax to become a highly productive source of revenue.

In most LDCs, the income tax has typically remained a tax on a minority of the citizens – the higher layers of income and also the group of salaried persons. Evidence about the reach of personal income taxation in LDCs

7. "A Manual on Government Finance Statistics", *International Monetary Fund,* June 1974, p. 163.
8. These stylized data are fairly consonant with reality. See, for example, Sen, A., "Levels of Poverty: Policy and Change", *World Bank Staff Working Paper* No. 401, July 1980.
9. For a critical assessment of the quality of data on income distribution in LDCs, see Bird, R.M. and Dewulf, L., "Taxation and Income Distribution in Latin America: A Critical Review of Empirical Studies", *IMF Staff Papers*, 1973, pp. 639-82.
10. Plasschaert, S., "Taxable Capacity in Developing Countries", *IBRD Report,* EC-No. 103, Washington, 1962.
11. Neumark, F., *Theorie und Praxis der modernen Einkommenbesteuerung* (Franke Verlag, Bern, 1947).

clearly carries testimony of this discrepancy.[12] The explanation of this state of affairs obviously relates to the fact already stressed that a quite honorable ordinal position (say, belonging to the 6th decile) in country Poor, in which no substantial middle class has emerged, in cardinal terms only allows for a very frugal level of living, with little or no (individual) taxable capacity. To transplant the scope of income taxation, as applied in country Rich, to country Poor, and to encompass the majority of the population, irrespective of their absolute income level, would flout any modern concept of equity; it would also be utterly unproductive as any gross revenue would be significantly eroded by the costs of administering a mass tax. Where there is no ample taxable capacity, no ample tax revenue can be forthcoming.

The contrast in the objective scope for extending the reach of income taxation in DCs and LDCs is sufficiently clear not to require lengthy proof. But interesting insights have recently been assembled in the approach to development, which attaches priority concern to meeting the "basic needs" of the mass of the population. The goal of achieving maximum growth of GNP is thereby weighted by the distributional dimension. Within this framework, an attack on "absolute poverty" is being urged. The derivation of an operational threshold level of absolute poverty owes, obviously, somewhat to conventions. The World Development Report of 1979 has posited the absolute poverty line at a calorie level of 2,250 per day, which corresponds to about the 45th percentile income group in India. Similar data for other LDCs indicate that (a) absolute poverty remains a pervasive problem, (b) the percentage of the population living in such conditions of deprivation is negatively correlated with per capita income levels. Thus in 1975, 68% of the population were estimated to live in absolute poverty in Ethiopia (at a Kravis-adjusted GNP per head of $200)[13] as against 14% in Mexico (for which the comparable per capita indicator stood at $1,429). Some countries, such as South Korea, Taiwan and Sri Lanka, provide happy exceptions to this overall correlation. And (c) a higher degree of vertical inequality of incomes also tends to be associated with a higher incidence of absolute poverty.

In the tax literature, the discrepancy in the taxpayer coverage of income taxation between LDCs and DCs has occasionally been expressed in terms of the ratio of the exemption levels of income taxation, i.e. the income below which no tax is statutorily due, on the one hand, and the per capita income in the same country, on the other hand. As should be expected, the ratio is much lower in DCs than in LDCs, generally speaking. This approach raises some technical problems: thus, the exemption may only apply to those who do not reach that exemption cut-off point; or, alternatively, it may function as an allowance and benefit even those whose income exceeds that point, the interpretation obviously differs somewhat in the two cases. This ratio, despite its drawbacks, conveys the message that the absolute level of income cannot be overlooked in a situation in which a large part of the country's population is suffering from deprivation.[14]

The third condition listed above is, of course, conceivable. Whether this actually happens is essentially an empirical question. On the normative level – how, according to prevailing tax principles, should tax formulae be devised – one again is faced with the dual dimension of absolute and relative income levels. In the hypothesis that, for example, the upper 20% of income recipients in country Poor were to enjoy, on the average, a real income equal to that of the upper 20% in country Rich, a strong case would exist for taxing the rich people in country Poor more stringently than the two top deciles in country Rich. But it is rather unlikely that, the more unequal distribution of income and wealth notwithstanding, the two highest deciles in country Poor, viewed as a subgroup, would enjoy the same income level in absolute terms as in country Rich. Even as regards the upper income classes, in normative tax theory, the absolute frame of reference cannot be completely ignored.

The overall conclusion of the preceding discussion is that the assumptions which would allow income taxation to account for a larger share of overall revenue in LDCs than in DCs are likely to be unrealistic in present-day circumstances, in which governments are in need of mobilizing large revenues – as is documented by statistical data. The main factors which explain the lower role of income taxation in LDCs are (a) the lower per capita level and (b) the high prevalence of persons in conditions of absolute poverty. This latter factor, obviously, is a major determinant of the low income per head.

But some other salient circumstances in LDCs come to mind which help explain the comparatively low ratio of income tax in LDCs. Let us take a look at them. We do not purport to indulge in a comprehensive description of socio-economic characteristics of LDCs,[15] but only to comment on those that are particularly relevant to our subject matter.

The sectoral breakdown of the economy

Studies testing the determinants of the overall tax ratio have established that the sectoral composition of production and income contributes towards explaining differential overall tax (and tax effort) ratios, alongside per capita income levels and the degree of openness of the economy. As already mentioned, the relative significance of mineral production (largely exported) was found to have a positive effect on the tax ratio in LDCs, whereas the relative size of the agricultural sector was negatively associated with a lower tax ratio. In LDCs, the agricultural sector contributes a much larger share of

12. Data on the coverage, in terms of the number of taxpayers, are not readily available in the scholarly literature. They must be unearthed in national reports on tax administration. For a discussion of some data, see Plasschaert, S., "Schedular and Global Systems of Income Taxation: Administrative Feasibility and Efficiency", Centre for Development Studies, UFSIA, Antwerp, paper 80/46, 1980.

13. As adjusted for purchasing-power; differences according to the methodology developed by Kravis, I., see Kravis, I., et al., *A System of International Comparisons of Gross Product and Purchasing Power* (The Johns Hopkins University Press, 1975).

14. For a critical discussion of such ratio, see Plasschaert, S., "Taxable Capacity in Developing Countries", *IBRD Report,* EC-No. 103, Washington, 1962, Appendix II.

15. Thus, Leibenstein, H., in his *Economic Backwardness and Economic Growth* (Wiley, 1957), listed no less than 32 characteristics of LDCs.

GDP than in DCs and employs even a higher percentage of the active population. It is well established that, for various economic, social and political reasons, agriculture is a "hard-to-tax" sector;[16] substantial undertaxation cannot easily be avoided. This is the case even when the agricultural sector comprises a significant number of fairly large firms which yield adequate income – as is the case in Western Europe. A fortiori, the agricultural sector will provide much less revenue when, as is characteristic in many LDCs, the sector is predominantly composed of tiny undertakings which only allow for a very modest level of living. The size and the composition of the agricultural sector are likely to affect more significantly the revenue performance of the income tax than of other branches of the tax system: thus, as noted earlier, export taxes can still be extracted from the peasants, if the cash crops are largely exported.

The extent of the subsistence sector

Connected with the previously discussed factor is the fact that in LDCs subsistence production is comparatively more widespread than in DCs.[17] Subsistence production occurs when the household itself consumes its output. While completely autarkic peasant units nowadays appear to be rare, the agricultural sector in LDCs is still characterized by a substantial degree of subsistence farming, as regards food items. Theoretically, the value of the self-consumed output is part of the ("imputed") income of the taxpayer and should be held taxable. Several countries attempt to incorporate a major item of imputed income, viz., food consumed by farmers, in presumptive methods of taxing agricultural incomes. But such procedures usually imply some degree of underassessment of the real income enjoyed by the taxpayer. Besides, subsistence farming is occurring to a more pronounced extent amongst the poorest peasants, thus raising equity objections against their being taxed. The virtual exclusion, de facto if not de jure, of subsistence agricultural output is not specific to the income tax, however. This production-consumption nexus remains internal to the agricultural unit. All in all, while the extent of subsistence agriculture contributes towards a low tax burden on agriculture and a modest overall tax ratio, it does not, as such, explain the comparatively lower role of income taxation in LDCs; as a matter of fact, income taxation, based on a notional, average yield from land (as in so-called cadastral systems), can be applied and would yield some revenue, whereas there is by definition no scope for indirect or foreign trade taxes, as subsistence involves no commercial flow whatsoever.

The prevalence of tiny production units

With the possible exception of mineral or plantation output destined for export channels, most production units in the agricultural and commercial sectors and even in "industry" (of which artisanal activities are usually considered part) tend to be small and poorly equipped. They achieve a low turnover and their owners are often badly attuned to the requirements for adequate reporting of data which would allow the correct assessment of taxable income. Hence, one should except a comparatively larger shortfall of actual vis-à-vis theoretical revenue in LDCs than in DCs – even assuming that tax administration would achieve a similar level of effectiveness as in DCs. For similar reasons, indirect taxes on turnover would also suffer from underassessment, but such shortfalls may be smaller than those in the field of income taxation. More readily ascertainable references, such as sales by wholesalers to retailers, render the assessment of indirect taxes less difficult than the tax on net income.

The segmented economy of LDCs

LDCs have been depicted as displaying a "dualistic" structure, with a large, low-productivity, traditional subsector (predominantly in agriculture) co-existing with a high-productivity mineral or agricultural subsector geared to exports.[18] The connotation is that the "modern" sector is an "enclave" with few linkages to the traditional sector (besides, it is often owned by foreign-based companies). This concept may, however, be extended and generalized to that of the segmented economy, in which subsectors of widely diverging levels of productive efficiency co-exist side by side, but with a low degree of interrelatedness and of mobility of factors from one (the traditional) to the other (the modern) sector. Thus, traditional peasantry, poorly equipped, and often with little saleable surplus, may co-exist with modern plantations; e.g. in India, textile products are supplied by both non-mechanized "cottage industries" and modern mills of the most recent vintage. More generally, artisanal activities attempt to survive against the threat of modern manufacturing. In cities of the developing world, food and other commodities can be purchased in air-conditioned supermarkets, in tiny shops and in village-type open markets; those markets obviously cater to different social classes. Banks provide credits at reasonable rates to companies in the modern sector, but, partly because of inadequate security, the peasant may have to rely on expensive money lenders. Regions of the same country are also often isolated from each other, not only by geographical barriers but by widely diverging levels of economic development.

In contrast, DCs typically have achieved a high degree of integration, which has largely eroded the distinctive features of segmented subsectors. Agriculture, accounting for a small percentage of GDP, employs few people but

16. For a detailed analysis in an individual country, see Herschel, F.J., "Taxation of Agriculture and Hard-To-Tax Groups", in *Fiscal Reform for Colombia: Final Report and Staff Papers of the Colombian Commission on Tax Report,* Musgrave and Gilles (ed.) (Harvard Law School, International Tax Program, 1971), pp. 387-415.
17. See *Anatomy of a Peasant Economy* (IRRI, Manila), as reviewed in "Village Economics", *The Economist*, 15 September 1979.
18. Reference should be made to the well-known studies of Boeke, J., Lewis, A., Fei, J., and Ranis, G., on the dualistic economy. For an attempt to explain the role of financial institutions in economic development, within a segmented economy, see McKinnon, R., *Money and Capital in Economic Development (The Brookings Institution, 1973).*

achieves a high output per acre. The artisanal subsector is of no significance, except for artistic gratification. The financial superstructure is highly developed and even, today, intimately intertwined with international financial markets. Goods and services flow readily towards regions and markets where they are most in demand. The behavioral pattern of the economic agents is predicted upon largely uniform motivations and standards: they all participate in a monetary economy. Their economic calculations are expressed in monetary units-of-account. One must notice, however, that in high-income countries the differentiation of occupations is obviously much greater than in more traditional societies, especially in the modern service sector, and that the various professions have become well organized as pressure groups lobbying for their interests – more than in LDCs, even if the latter happen to have more or less democratic regimes.

For our purposes, the "segmentation" characteristic of LDCs carries, in my view, three implications. First, as traditional sectors are hard to tax in LDCs, the income tax as actually implemented is likely to be predominantly levied on the modern sectors. The quasi-exemption, de facto, of the traditional subsectors reduces the yield from income taxes; it also distorts competitive conditions between the modern and traditional sectors. Second, the "segmentation" thesis raises the question whether the global type of income taxation, with its implied uniform treatment of income recipients, is really suited to the fragmented economy in LDCs; perhaps a schedular approach, with its overt differentiating treatment per sector, may be more appropriate. A final although less important commment is that the lobbying activities of various groups partly explain the high propensity of modern income taxes in DCs towards the provision of special (favorable) statutes for various activities and social groups, thus contributing towards more complex tax legislation.

Lower administrative effectiveness

The state of underdevelopment is pervasive, in which not only economic but also non-economic variables fall short of the standards reached in more fully developed countries. Administrative capabilities are usually highly deficient: as the income tax with its modern functions and procedures is administratively very demanding, the underadministration of the income tax is another factor which accounts for the typically lower relative yield of income taxation in LDCs, as compared to DCs; several other tax handles, such as import duties, are much less vulnerable to administrative shortcomings. Incidentally, this also corroborates the view, strongly endorsed by the present writer, that in improving the performance of the tax system in LDCs, strengthening the administrative procedures deserves at least as much attention as substantive reform; anyhow, without the former, the latter would be of little avail.

FINAL COMMENTS

In this paper, an attempt was made to explain why, typically, the income tax is comparatively less important in LDCs than in DCs. Income taxation accounts for a lower percentage of GDP than in DCs. This, however, could be linked to lower "taxable capacity" in LDCs and, hence, to a lower overall "tax ratio" (to GDP). But this factor only provides a partial answer. As a matter of fact, the income tax system in LDCs mobilizes a lower portion of overall tax revenue than in DCs. This suggests that the levying of income taxes runs into more problems in the underdeveloped world than in the industrial countries.

Several explanatory variables were discussed. The widespread incidence of so-called absolute poverty in LDCs, especially in the least-developed ones, precludes the application of individual income taxation to the masses, both on equity and administrative grounds. Agriculture provides a large portion of employment and of GDP in LDCs. It is a "difficult to tax" sector; part of the output is not marketed by the peasants. Income taxation, in its modern versions, imposes heavy demands on the tax administration, and in LDCs the latter also typically tends to be seriously incapacitated by blatant deficiencies.

The economic and administrative obstacles towards a wide and effective implementation of income taxation in LDCs also explain why the revenue authorities rely comparatively more on other tax handles which in developed market economies are no longer of real significance. Today, import duties typically are the main source of revenue in LDCs – although, in a highly protective environment, the role of protecting domestic production which is frequently assigned to high import duties conflicts with the revenue objective of import taxation. Besides, LDCs, which export sizeable amounts of agricultural or mineral products, tend to rely on export duties. For all practical purposes, both import and export duties are no longer part of the kit of tax instruments of which developed countries avail themselves.

EUROPEAN COMMUNITIES:

Twelfth Council Directive

Harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: expenditure not eligible for deduction of value added tax[1]

I. GENERAL (EXPLANATORY MEMORANDUM)

1. Article 17(6) of the 6th VAT directive provides as follows:

Before a period of four years at the latest has elapsed from the date of entry into force of this directive, the Council, acting unanimously on a proposal from the Commission, shall decide what expenditure shall not be eligible for a deduction of value added tax. Value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

Until the above rules come into force, Member States may retain all the exclusions provided for under their national laws when this directive comes into force.

2. The existing exclusions from the right to deduct input tax are extremely varied. In most Member States, the sometimes significant exclusions from and limitations on this right apply primarily to expenditure on entertainment and hospitality and to the purchase and use of motor vehicles.

3. This wide variety of national rules is attributable to a number of factors, including, in particular, the following:

Some countries withhold or limit the right to deduct input tax so as to avoid or greatly simplify those cases where a distinction has to be made between expenditure which relates to the private needs of a taxable person or of other persons and expenditure which is linked to a taxable person's economic activities. This facilitates the task of the tax authorities and is intended to reduce or obviate tax fraud.

Other countries, in accordance with Art. 17(2) and (3), allow taxable persons to deduct in full in respect of all the expenditure in question or of the most important categories of such expenditure, with only non-business expenditure being excluded.

Thus, the individual Member States made use in quite different ways of the possibility afforded by Art. 11(4) of the second VAT directive (repealed by the sixth VAT directive), which stipulated:

Certain goods and services may be excluded from the deduction system, in particular those capable of being exclusively or partially used for the private needs of the taxable person or of his staff.

Member States, in moving over to the system provided for in the 6th directive, have to a considerable extent simply retained in their legislation the exclusions for which they had already opted when the common VAT system was set up.

4. The present situation is not consistent with the requirements of a uniform basis of assessment and a non-discriminatory system of taxation.

Taxable persons in a Member State in which tax is fully deductible for all expenditure except non-business expenditure are afforded more favourable tax treatment than taxable persons in a Member State in which certain categories of expenditure are excluded from the right to deduct input tax. This difference in treatment may lead to some distortion of competition in international trade in goods and services insofar as it is reflected in the prices of the goods and services.

The fact that only certain Member States refuse to allow deductions has economic drawbacks in those States for the industries that are particularly affected by this prohibition (notably the motor vehicle industry and the hotel and catering industry). The budgetary benefit to the State whose receipts are initially increased by the ban on deduction may thus eventually decline or even be completely eroded.

If the present situation were left unchanged, the equitable collection of VAT-based own resources might be jeopardized, without there being any possibility of financial compensation (except for the purchase of motor vehicles and oil products).

5. In addition, since certain categories of expenditure, even where incurred in connection with the normal operation of a business, often serve private needs too and since apportionment of such expenditure between business and private use cannot be accurately verified, that exercise of the right to deduct input tax presents the risk of abuse or tax evasion, giving rise to distortion of competition.

Account must be taken in this regard of the practical effect of the new legal situation brought about by the adoption of the 8th directive. The right to claim the refund of VAT invoiced in one Member State to a taxable person established in another Community State is now recognized, but here again there are risks of abuse or tax evasion in allowing a taxable person to obtain, simply by presenting invoices, a refund of the tax charged on the cost of using a private car, travel expenses, and hotel or restaurant bills.

The principal limitations on the right to deduct input tax in certain or in all Member States are under the following headings:

1. Expenditure on food and drink
2. Expenditure on lodging and accommodation
3. Expenditure on entertainment
4. Gifts
5. Expenditure on passenger cars

All the Member States except one impose limitations on the right to deduct in respect of categories 1 and 4. Where deductibility exists it is inevitably for expenditure either away from the office base or else for contacts outside the business.

In the case of passenger cars, there is a rather clear distinction between the four or five Member States who permit deductions in respect of the purchase of motor vehicles on the one hand and those who permit no such deductions at all. There is a similar division between Member States over allowing deductions for running costs.

In the view of the Commission the above analysis shows that there is no single consistent pattern in the practices of the Member States in refusing deduction of VAT. Nevertheless, where restrictions are imposed on the right to deduct, there is an implicit recognition that expenditure which has the characteristic of final consumption should bear VAT. The Commission, therefore, considers that in order to harmonise the differing practices in the Member States, to overcome the potential distortions of competition in the differing practices and to eliminate the risk of fraud, deduction should be prohibited in the most typical cases where final consumption forms part of the direct operational costs of the undertaking.

It is in the light of these considerations that the Commission pre-

1. Proposal submitted by the Commission to the Council on 25 January 1982. Document COM(82) 870 final. In order to facilitate reading, this document has been slightly re-arranged by the editors in such a manner that the commentaries on the articles follow immediately these articles in lieu of preceding them as is the case in the original document.

sents to the Council the proposal for a 12th directive on the harmonization of the laws relating to turnover taxes.

II. PROPOSAL FOR A TWELFTH COUNCIL DIRECTIVE

On the harmonization of the laws of the Member States relating to turnover taxes - common system of value added tax: *expenditure not eligible for deduction of value added tax*

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common System of value added tax: uniform basis of assessment,[2] and in particular Article 17(6) thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

Whereas Article 17(6) of Sixth Directive 77/388/EEC stipulates that the Council shall decide what expenditure shall not be eligible for a deduction of value added tax;

Whereas some items of expenditure, even where incurred in connection with the normal operation of a business, nevertheless have the characteristics of final consumption and apportionment of such expenditure between business and private use cannot be accurately verified;

Whereas the nature of such expenditure presents the risk of abuse or tax evasion, not only on the part of resident taxable persons, but also on the part of non-resident taxable persons who are entitled to the refund of tax in a Member State other than that in which they are resident;

Whereas Article 17(6) of Sixth Directive 77/388/EEC stipulates that value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment;

Whereas the establishment of common rules on the expenditure referred to in Article 17(6) of the aforementioned Directive is not intended to affect the general arrangements governing the right to deduct that result from First Council Directive 67/227/EEC[3] and from the Sixth Council Directive 77/388/EEC or the other cases of non-deductibility that result from the Sixth Directive, and in particular from Articles 17(7), 24(5), 25(5) and 26(4) thereof;

Whereas it is necessary to achieve greater uniformity of the basis of assessment for the collection of own resources as provided for in Council Decision 70/243/ECSC, EEC, Euratom of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources;[4]

Whereas the harmonization of national provisions relating to exclusion of the right to deduct contributes at the same time to the harmonization of the arrangements for the refund of value added tax to taxable persons not established in the territory of the country as provided for in Eighth Council Directive 79/1072/EEC,[5]

2. Official Journal (O.J.) No. L. 145, 13.6.1977, p. 1.
3. O.J. No. 71, 14.4.1967, p. 1301.
4. O.J. No. L 94, 28.4.1970, p. 19.
5. O.J. No. L 331, 27.12.1979, p. 11.

HAS ADOPTED THIS DIRECTIVE:

III. ARTICLES AND COMMENTARY

Article 1

1. Value added tax shall not be deductible in respect of expenditure on the purchase, manufacture, importation, leasing or hire, use, modification, repair or maintenance of passenger cars, pleasure boats, private aircraft or motor cycles.

Nor shall value added tax be deductible in respect of expenditure on supplies (fuels, lubricants, spare parts etc.) for, or services performed in relation to, such vehicles and craft.

"Passenger car" means any road vehicle (including any trailer) other than one which, by its design and equipment, is intended solely for the transport of goods or is intended for industrial or agricultural use or has a seating capacity of more than nine persons including the driver.

2. The exclusions of the right to deduct referred to in paragraph 1 shall not apply to vehicles or craft which are:
(a) used for carriage for hire or reward;
(b) used for driving training or instruction;
(c) hired out;
(d) part of the stock in trade of a business.

Concerning Article 1

Article 1 concerns the exclusion of the right to deduct the tax on expenditure relating to passenger cars.

This exclusion is justified by the fact that this type of vehicle necessitates expenditure which, even if it is incurred in connection with an undertaking, is not necessarily linked directly and exclusively to the activities of that undertaking.

However, this exclusion is accompanied by a number of riders designed to maintain the right to deduct input tax where vehicles constitute stock in trade or are the subject of the economic activity of certain taxable persons (taxis, driving schools, car hire firms).

Article 2

1. Value added tax shall not be deductible in respect of transport expenses incurred on business travel by a taxable person or by members of his staff; "business travel" means a journey undertaken by a taxable person or by a member of his staff for business reasons away from the place of establishment or away from the place at which the traveller's functions are exercised.

2. The exclusion of the right to deduct referred to in paragraph 1 shall not apply to transport expenses relating to the movement of an undertaking's staff between particular places of work or to those relating to transport of staff to and from their homes.

Concerning Article 2

The exclusion provided for in Article 2 concerns transport costs incurred on business travel. The justification for this provision is identical to that given in respect of Article 1.

Paragraph 2 of Art. 2 stipulates that the exclusion of travel expenses does not extend to transportation costs borne by an undertaking which relate to the movement of staff between different places of work - to work sites, for example - or to the collection of staff from their homes.

Article 3

1. Value added tax shall not be deductible in respect of expenditure on accommodation, food and drink.

2. The exclusion of the right to deduct referred to in paragraph 1 shall not apply:
(a) to expenditure incurred by a taxable person in respect of the supply of accommodation, meals, food or drink for consideration;
(b) to expenditure on accommodation provided free of charge for security or caretaking staff on works, sites or business premises.

Concerning Article 3

The purpose of this provision is to exclude from the right to deduct a category of expenditure which is primarily consumption expenditure, even if it is incurred in connection with the operation of an undertaking. This is in accordance with the general approach that expenditure on accommodation, food or drink should not escape taxation altogether solely because it is borne by an undertaking.

It is made clear that this exclusion does not concern those economic sectors whose activities consist in providing the goods or services which are the object of the exclusion (the hotel, restaurant and suppliers and manufacturers of food).

Nor does the exclusion cover works canteens, even where these can operate only with the help of subsidies, provided these subsidies are included in the taxable amount in accordance with Art. 11(A)(1)(a) of the 6th directive.

In the event of subsidies not being included in the taxable amount, the provisions of Art. 19(1) of the 6th directive (application of the pro rata deduction) must be applied.

Exclusion from the right to deduct does not apply to expenditure incurred by an undertaking in providing accommodation free of charge for security staff.

Article 4

Value added tax shall not be deductible in respect of expenditure on entertainment, including expenditure on hospitality extended to business contacts or, more generally, persons outside the business or in respect of expenditure relating to buildings, parts of buildings or their fittings intended primarily for such entertainment.

Article 5

Value added tax shall not be deductible in respect of expenditure on amusements and luxuries.

"Expenditure on luxuries" means expenditure which, by its nature and amount, does not constitute normal operating expenditure, or which relates to items which are not normally installed as fittings in buildings.

Concerning Articles 4 and 5

These exclusions, which concern expenditure on entertainment, amusements and luxuries, stem from the same arguments as those outlined above. Furthermore, the principle of such an exclusion is already laid down in Art. 17(6) of the 6th directive.

Article 6

The words "Article 17(6)" in Article 13 B.(c) of Sixth Directive 77/388/EEC are hereby replaced by the following: "the provisions of Twelfth Directive . ./. . ./EEC".

Article 7

Member States shall bring into force the provisions necessary to comply with this Directive not later than 1 January 19 . . .

This Directive shall apply only with respect to value added tax charged on the purchase of goods or services invoiced, and on imports effected, from that date.

Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field covered by this Directive. The Commission shall inform the other Member States thereof.

Article 8

The second subparagraph of Article 17(6) of Sixth Directive 77/388/EEC shall cease to have effect in each Member State as from the date of implementation of this Directive.

Article 9

This Directive is addressed to the Member States.

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Canada: The 1982 Changes to the Taxation of International Income

By Allan R. Lanthier

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Allan R. Lanthier is a partner of Arthur Young, Clarkson Gordon, Montreal. The author wishes to thank Mr. John H. Meek of Arthur Young, Clarkson Gordon, Toronto, for comments on an earlier draft of this article.

I. INTRODUCTION

Further to a Budget presented to the Canadian House of Commons on 12 November 1981, and to numerous subsequent retrenchments and modifications (including a replacement of the Minister of Finance), draft amendments to the Canadian Income Tax Act (hereinafter ITA) were finally tabled on 7 December 1982. These changes will have a significant impact on the taxation of international income, particularly in respect of income earned by residents of Canada through share interests in foreign corporations of which they own 10% or more (foreign affiliates). In addition, draft amendments to the foreign affiliate regulations to the ITA were issued by the Department of Finance on 4 November 1982. At the time of writing, neither the draft amendments to the ITA nor to the related Regulations (referred to collectively in this article as the "1982 changes") had been enacted. However, it is expected that, after certain technical revisions have been made, the 1982 changes will be passed into law, generally with retroactive effect.

In separate articles in the August-September 1982 issue of the *Bulletin,* Heward Stikeman and Nathan Boidman provided excellent analyses of the Canadian rules for the taxation of offshore income[1] and of foreign investment in Canada.[2] The present article will review, within the context of these general rules, those of the 1982 changes which are most significant.

II. TAXATION OF FOREIGN INVESTMENT IN CANADA

A. Withholding tax exemptions on interest income

Non-residents of Canada are generally taxed at a flat rate of 25% on the gross amount of certain types of passive income, including interest, dividends, rents and royalties, paid or credited by residents of Canada. The rate of tax is reduced to 15% in respect of interest paid to non-related persons resident in prescribed countries[3] on obligations issued before 1 January 1976, and may also be reduced under any of the international tax conventions to which Canada is party.

While interest payments are generally subject to the non-resident withholding tax, the general rules provide for certain exemptions. Perhaps the most important of these are the exemptions for interest payable on Canadian government or government-guaranteed obligations and on prescribed long-term corporate indebtedness.[4] Interest on long-term corporate indebtedness will qualify for exemption if it is payable to a non-related person on any obligation issued after 23 June 1975, provided the Canadian debtor is not required to repay more than 25% of the principal amount within 5 years from its date of issue (except in the event of failure or default, or if the terms of the obligation are changed by legislation or judgment of a court, board or commission). These exemptions were enacted to facilitate the raising of finance capital in Canada, and can result in significant advantages in many situations. For example, interest on qualifying debt obligations paid to a resident of the Netherlands would be exempt from Canadian withholding tax, and would also be exempt from Dutch domestic tax if the obligation is secured by real property situated in Canada.[5]

1. H.H. Stikeman, "Taxation of Offshore Income and the Canadian Treaty Network", 36 *Bulletin for International Fiscal Documentation* 8-9, p. 351.
2. N. Boidman, "Structuring Investments and Business Start-Ups in Canada", 36 *Bulletin for International Fiscal Documentation,* 8-9, p. 362.
3. The countries which have been prescribed for this purpose are Australia, Denmark, Finland, France, Germany, Ireland, Jamaica, Japan, the Netherlands, New Zealand, Norway, South Africa, Sweden, Trinidad and Tobago, the U.K. and the United States (being countries which had entered into tax conventions with Canada as of 1 January 1976).
4. Other exemptions which have been prescribed include exemptions for interest on foreign currency obligations entered into with non-related persons, to the extent that interest paid thereon relates to a business carried on outside Canada, on certain obligations secured by real estate situated outside Canada, and on foreign currency deposits of Canadian banks with non-related persons. Certain entities, such as non-profit organizations, charitable organizations and pension trusts or corporations, may also obtain exemption, if the entity is exempt from the income tax of its country of residence and it obtains a certificate from the Canadian tax authorities.
5. By virtue of the proportionate tax exemption contained in Art. XVIII of the current Canada–Netherlands tax convention. Discussions are underway between officials of both countries with respect to a re-negotiation of the convention, and it is possible that this exemption would not survive in a new convention.

The exemptions from non-resident withholding tax in respect of interest on government, government-guaranteed and long-term corporate indebtedness were all scheduled to expire, effective for obligations issued after 31 December 1982. The 1982 changes have now extended these exemptions to obligations issued before 1 January 1986.

Other 1982 changes affecting the withholding tax on interest income are as follows:

- Interest paid or credited after 12 November 1981 by Canadian banks or certain other financial institutions to a non-related person will be exempt from non-resident withholding tax if paid on Canadian currency deposits from a branch or office situated outside Canada. Under the former rules, interest paid on foreign currency deposits of a Canadian bank to a non-related person (whether through Canadian or foreign branches) was exempt from withholding tax. The 1982 change, together with the former exemption, will mean that interest on all deposits of foreign branches of Canadian banks (whether in Canadian or foreign currency) will be exempt.
- The various withholding tax exemptions in respect of interest income will generally not be available in respect of obligations issued after 12 November 1981 where any portion of the interest is contingent or dependent on the use of or production from property in Canada. To the extent that amounts paid on participating debt obligations constitute "interest" in a particular situation,[6] the exemptions described above will therefore no longer apply. This new rule will affect, inter alia, the exemptions in respect of government and government-guaranteed indebtedness, long-term corporate indebtedness, foreign currency deposits of Canadian Banks, and Canadian dollar deposits of foreign branches of Canadian banks, all as discussed above.

B. Reduced withholding tax on dividend income

Non-residents are also generally taxed at a flat rate of 25% (subject to reduction by treaty) on the amount of any dividends paid by corporations resident in Canada. In the past, a reduction of 5 percentage points applied in respect of dividends paid by a Canadian resident corporation, if the corporation obtained a prescribed "degree of Canadian ownership" (generally the ownership of at least 25% of the corporation's shares by Canadians). The general rate of withholding tax was therefore 20% in respect of dividends paid by qualifying corporations to residents of non-treaty countries, and was 5 percentage points below the rate established by the applicable tax convention in other cases.

This provision was originally enacted to encourage foreign parent companies to increase the Canadian equity ownership of Canadian subsidiaries. However, the Canadian authorities have now concluded that the incentive was not effective, and the special 5% reduction is to be repealed for dividends paid after 12 November 1981, other than for dividends declared on or before that date.

C. Thin capitalization provisions

Under Canada's "thin capitalization" provisions, interest paid by a corporation resident in Canada to a "specified non-resident"[7] is disallowed to the Canadian payor to the extent that debt owing to the non-resident exceeds a prescribed 3:1 debt/equity ratio. For this purpose, "equity" includes the Canadian corporation's retained earnings on a non-consolidated accounting basis, its contributed surplus, and its paid-in capital. Any interest which is disallowed under these provisions remains subject to non-resident withholding tax in the hands of the recipient, and is therefore effectively treated as a dividend payment for Canadian tax purposes.

In the past, the definition of "equity" for purposes of the above provisions was somewhat anomalous, in that it included all of a Canadian corporation's contributed surplus and paid-in capital, even where the non-resident had not invested directly in the corporation. For instance, in situations where a non-resident invested $1,000 Canadian in the capital stock of a wholly-owned subsidiary resident in Canada (Canco 1), and where Canco 1 in turn invested the same $1,000 in capital stock of its own wholly-owned Canadian subsidiary (Canco 2), it appeared that the non-resident could invest in debt of up to $3,000 Canadian in each of Canco 1 and Canco 2 (for a total of $6,000) without a disallowance of interest expense to either corporation. The 1982 changes now provide that, for taxation years commencing after 12 November 1981, contributed surplus will only form part of equity for purposes of these provisions to the extent that it was contributed directly by the specified non-resident shareholder. Similarly, paid-in capital will exclude any amounts in respect of shares owned by a person other than the specified non-resident. Any interest on the $3,000 debt in Canco 2 in the foregoing example would accordingly be disallowed in future and the thin capitalization provisions.

This change will also affect situations where a non-resident shareholder has less than a 100% interest in a resident Canadian corporation, and where some portion of the contributed surplus or paid-in capital has been invested by other, non-related persons. In future, that portion of the contributed surplus or paid-in capital applicable to the non-related persons will not be taken into account in computing any possible disallowance of interest expense in respect of the specified non-resident.

D. Loans to non-resident shareholders

Where a corporation resident in Canada (or prescribed persons related to the corporation) makes a loan to a non-resident shareholder (or to certain non-residents related to a shareholder), the amount of the loan is deemed to have been paid to the non-resident as a dividend unless certain exemptions apply. Loans which are repaid within one year from the end of the taxation year of the lender

6. For comments in this regard, see Boidman, note 2, at page 373.
7. A specified non-resident for this purpose is a non-resident who, either alone or together with related persons, owns 25% or more of any class of shares of the Canadian corporation, or any other non-resident related to such shareholders.

in which they are made are exempt from these provisions, provided the loan is not part of a series of loans and repayments. A second exemption applies to loans made in the ordinary course of a money-lending business, provided bona fide arrangements are entered into at the time the loan is made for repayment thereof within a reasonable time. If a loan is not exempted, the normal rates of non-resident withholding tax applicable to dividends (subject to reduction by treaty) apply on the full amount of the loan.

In the past, these provisions only applied to actual loans, and did not appear to apply to other forms of indebtedness, such as balances of sale. The 1982 changes will, however, extend these rules to cover all forms of indebtedness, effective for indebtedness incurred after 31 December 1981. Indebtedness which is repaid within one year, as well as balances of sale arising in the ordinary course of business, will continue to be exempt from these provisions.

Further changes have been introduced in respect of shareholder debt, in situations involving low-interest or non-interest bearing loans or indebtedness. Effective for the 1982 and subsequent taxation years, amounts owing by non-resident shareholders (or by certain non-residents related to a shareholder) may give rise to a taxable benefit, even where the amounts are repaid within one year. The benefit is based on imputed interest calculated at a prescribed rate (12% for the first quarter of 1983). The benefit is reduced by the amount of any interest actually paid by the non-resident, and is eliminated if interest is payable at a rate at least equal to that which would have been agreed upon between non-related persons. The amount of any benefit is deemed to be a dividend paid to the non-resident, subject to non-resident withholding tax. Previously, these rules only applied to non-resident shareholders who were individuals, and not to corporations.

There are certain technical anomalies in the drafting of the rules related to imputed interest benefits. For example, although the clear intent is that loans or indebtedness will not give rise to imputed interest to the extent that the amounts have themselves been subject to non-resident tax (further to the rules outlined above), it is questionable whether the present drafting achieves this result.

It will be more important than ever, having regard to the 1982 changes, to monitor amounts owing by non-resident shareholders on an on-going basis. Reference should also be made in this regard to the general rules applicable to loans to any non-resident (whether or not a shareholder), which are outlined below at II.B.

E. Refundable tax on Canadian private corporations

Corporations resident in Canada are taxed at normal rates on investment income (which generally includes for this purpose income from property as well as one half of capital gains, but excludes dividend income). However, a portion of the taxes paid on such income by a corporation which qualifies as a "private corporation"[8] is refundable to the corporation on eventual payment of taxable dividends to its shareholders. The amount which is potentially refundable is 16⅔% of the investment income. This meant that, in the past, a non-resident who held investments through a Canadian private corporation would only be subject to an effective Canadian corporate tax rate of approximately 33⅓% (assumed basic corporate tax rate of 50%[9] less refund of 16⅔% on eventual payment of taxable dividends by the private corporation to its non-resident shareholder), plus the normal non-resident withholding tax applicable to the payment of such dividends.

The purpose of these refundable tax provisions was to ensure that the combined tax payable by the Canadian private corporation and those of its shareholders who were individuals resident in Canada would approximate the tax that would have been payable had the individuals earned the investment income directly. However, one effect of the refundable tax provisions was a reduction of the effective Canadian tax rate on investment income of private corporations, even where those corporations were owned by non-residents.

The 1982 changes now provide that, effective for taxation years commencing after 12 November 1981 (and subject to certain transitional provisions), the 16⅔% refund will only apply to companies which qualify as "Canadian-controlled private corporations"[10] throughout a particular taxation year. While any balances of refundable tax accumulated prior to that time will continue to be eligible for refund on eventual payment of taxable dividends to non-resident shareholders, the effective Canadian tax rate on any investment income earned in future by non-qualifying corporations will be significantly increased as a result of this change. Note, however, that non-resident shareholders will continue to benefit from the refundable tax provisions in situations where Canadian ownership of the private corporation is sufficient to meet "Canadian-controlled private corporation" status.[11]

III. TAXATION OF FOREIGN AFFILIATES

A. Summary of the general rules

Before reviewing the 1982 changes to the foreign affiliate provisions, it may be useful to set out a summary of the basic structure of the rules in this area.

8. A "private corporation" is defined for this purpose as a corporation that was resident in Canada, was not a public corporation as defined, and was not controlled, directly or indirectly, by one or more public corporations (para. 89(1)(f), ITA).
9. The actual corporate tax rate will depend on the Canadian province in which the income is earned, and for 1982 varied from 47.8% to 53.8%.
10. A "Canadian-controlled private corporation" generally means a private corporation, other than a corporation controlled directly or indirectly by one or more non-residents, one or more public corporations, or by any combination thereof (para. 125(6)(a), ITA). It is to be noted that, under this definition, a corporation controlled 50% by residents of Canada and 50% by non-residents would qualify as Canadian-controlled.
11. Also, a different regime applies to Canadian corporations which qualify as "non-resident-owned investment corporations", and the 1982 changes have generally not affected the taxation of such corporations. For a summary of the rules in this area, see Boidman, note 2, at page 370.

1. Taxation of dividends

A resident of Canada who receives dividends from a non-resident corporation which does not qualify as a foreign affiliate is subject to normal rates of Canadian tax on the gross amount of the dividend income, subject to possible credit for any foreign tax withheld on the dividend payment.[12] However, an entirely different regime applies in respect of dividends received by corporations resident in Canada from foreign affiliates. A non-resident corporation qualifies as a "foreign affiliate" if the Canadian shareholder owns directly or indirectly 10% or more of any class of shares.

Dividends received by a corporation resident in Canada from foreign affiliates are initially included in income, but deductions are then allowed for all or a portion of the dividends in computing the Canadian corporation's taxable income. The amount of the deduction depends on the surplus account of the foreign affiliate from which the dividend is prescribed to have been paid. Where a dividend is paid out of "exempt surplus", a deduction is allowed in computing taxable income equal to the full amount of the dividend.[13] Where a dividend is out of "taxable surplus", deductions are available related to both the underlying foreign tax applicable to the earnings being distributed, as well as any foreign withholding taxes applicable to the dividends.[14] The overall impact of these provisions is that there will be no Canadian tax on dividends received out of taxable surplus if the total foreign tax burden is at least 46%, which is the basic Canadian corporate tax rate.

After-tax business income earned in treaty countries[15] after an affiliate's 1975 year forms part of "exempt surplus". Exempt surplus also includes after-tax business income from treaty as well as non-treaty countries for the years 1972-1975 inclusive. Post-1975 after-tax business income earned in non-treaty countries forms part of "taxable surplus".

Dividends paid by a foreign affiliate are generally paid first out of exempt surplus to the extent available, and next out of taxable surplus. Any dividend payments which exceeds an affiliate's exempt and taxable surplus balances are considered to come out of "pre-acquisition surplus", a notional or balancing account for which no computations are made. Dividends received by a corporation resident in Canada out of pre-acquisition surplus are not subject to tax,[16] but rather are treated as a return of capital. The amount of such dividends (net of any foreign withholding tax) accordingly reduces the tax cost of the shares on which the dividends were paid.

2. Taxation of passive income (FAPI)

A separate set of rules applies with respect to certain types of passive income earned by a foreign affiliate which is also a "controlled foreign affiliate" (CFA). A CFA is defined to mean a foreign affiliate controlled, directly or indirectly in any manner, by the taxpayer, by a related group of which the taxpayer was a member, or by the taxpayer and not more than 4 other persons resident in Canada (whether related or non-related). A Canadian resident shareholder (corporation or individual) is taxable on its share of the CFA's passive income on an attribution basis, whether or not the income has actually been distributed as dividend payments.

The passive income which is subject to these attribution rules is defined as foreign accrual property income, or "FAPI". Generally, FAPI includes property income and income from a business other than an active business, as well as one-half of capital gains (net of capital losses) accruing after an affiliate's 1975 year, other than capital gains on assets used directly in an active business. Dividends between foreign affiliates are excluded from FAPI, as is income received from another foreign affiliate if the amount was paid out of active business earnings of the payor affiliate. If FAPI of a particular controlled foreign affiliate is $5,000 Canadian or less, there is no attribution. However, where the attribution rules do apply, there is no distinction between income earned in treaty versus non-treaty countries.

Where FAPI has been included in income, appropriate deductions are available for any underlying foreign profits tax. There is generally no further Canadian tax when the FAPI income is repatriated to Canada as dividend payments, although further deductions may be available at that time for foreign withholding taxes imposed on the dividends.

3. Dispositions of foreign affiliate shares

Where a resident of Canada sells shares of a foreign affiliate, one half of any capital gain is included in income and taxed at normal rates. Similarly, where a controlled foreign affiliate of a Canadian taxpayer sells shares of another foreign affiliate, one half of any capital gain is included in FAPI for attribution to its Canadian shareholders.

In both of the above situations, it may be possible to reduce the capital gain through the use of a special election whereby amounts that would otherwise be proceeds of disposition for capital gains purposes may be converted into deemed dividends for purposes of Canadian taxation, without the payment of actual dividends. This election is found under subsection 93(1), ITA, and is available to corporations (but not individuals) resident in Canada in respect of dispositions of directly-held affiliates, as well as dispositions of affiliates held indirectly through other foreign affiliates.

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12. In respect of foreign dividends received by a shareholder who is an individual, the foreign tax credit is limited to 15% of the amount of the income, with any excess foreign taxes being deductible in computing net income (subsection 20(11) and para. 126(7)(c), ITA). In addition, any shareholder (individual or corporation) may choose to deduct all or any portion of foreign withholding taxes in computing net income, rather than taking a direct tax credit (subsection 20(12), ITA).
13. While this is therefore no imposition of the general corporate tax in respect of dividends received out of exempt surplus, the special 25% refundable tax under Part IV, ITA (discussed further below) may apply in certain situations.
14. In addition, a special deduction may be available in respect of dividends paid out of taxable surplus, where the shares of the foreign affiliate were owned at the end of 1975 (subsection 113(2), ITA).
15. "Treaty" countries are defined for this purpose as those countries listed in Regulation 5907(11) to the ITA, and are generally countries with which Canada has either concluded a tax convention, or has commenced negotiations with a view to implementing a convention.
16. However, as is the case with dividends out of exempt surplus, the special 25% tax under Part IV, ITA may apply in certain situations.

The filing of an election under subsection 93(1) will often reduce, although not necessarily eliminate, the capital gain for Canadian tax purposes. In respect of a disposition by a controlled foreign affiliate of shares of another foreign affiliate, an election can be made to reduce the gain by the amount of any exempt surplus as well as taxable surplus attributable to the shares being disposed of. All inter-affiliate dividends are excluded from FAPI, and the only effect of such an election is to move the surplus balances from the affiliate being disposed of to its former shareholder, thereby deferring Canadian taxation until the funds are eventually repatriated to Canada as dividends. In respect of dispositions of directly-held affiliates, an election will generally only be made in respect of exempt surplus, and not taxable surplus, of the foreign affiliate being disposed of. This is because, in the situation of directly-held affiliates, the Canadian shareholder is deemed to have received dividends out of any surplus elected upon, and deemed dividends received by a Canadian corporate shareholder out of taxable surplus are normally subject to Canadian taxation, in accordance with the rules previously discussed.[17]

B. Financing of foreign affiliates

The balance of this article will concentrate on those of the 1982 changes to the foreign affiliate rules which are of widest general interest.[18] However, we will first review one significant area in which changes were originally proposed, and where these changes have not gone forward. These relate to the financing of foreign affiliates.

Where a corporation resident in Canada loans money to a non-resident person (whether related or non-related), and the loan remains outstanding for one year or longer without interest at a "reasonable rate" having been included in computing the lender's income, interest is imputed at a prescribed rate and is deemed to have been received by the Canadian lender. The prescribed rate is adjusted quarterly in accordance with the prevailing level of Canadian interest rates. For the first quarter of 1983, the prescribed rate was 12%.

An important exception to the above rules is that interest is not required to be charged on loans to a "subsidiary controlled corporation",[19] provided the borrowed money is used by the subsidiary for the purposes of gaining or producing business income.[20] The definition of a subsidiary controlled corporation does not extend to second-tier foreign affiliates which are not owned directly by the Canadian shareholder, so that loans made from Canada to such corporations would not qualify for the exemption. However, Revenue Canada (the assessing and collections branch of the Government) has expressed the view in the past that, where a Canadian corporation loans funds without interest to a wholly-owned foreign subsidiary, and where the only undertaking of the wholly-owned subsidiary is investing in its own subsidiaries and providing them with financial assistance in the form of interest-bearing loans, interest will not normally be imputed to the Canadian shareholder provided the funds are ultimately used by the second-tier subsidiary for the purpose of earning business income. Interest would, however, be imputed in this type of situation if the wholly-owned foreign subsidiary made interest-free loans to its own subsidiaries. It should also be noted that, where a Canadian corporation makes an interest-free loan to its subsidiary controlled corporation, and the principal activity of the subsidiary consists of financing other corporations through interest-bearing loans, such activities would normally constitute the conduct of an active business (depending on the nature and extent of the finance activities), so that the exemption would also apply in this situation.

The exemption discussed above in respect of loans to subsidiary controlled corporations has assisted in the financing of foreign affiliate groups in many situations. For example, if a corporation resident in Canada incorporates a subsidiary to carry on a finance business in the Netherlands, capitalization of the affiliate by way of non-interest bearing loans rather than share capital may reduce the imposition of Dutch capital tax. Also, it is understood that rulings may be available from the tax authorities in the Netherlands in certain situations whereby income subject to tax in the Netherlands would be reduced by an "imputed" interest expense in respect of such non-interest bearing loans.

In the 12 November 1981 federal Budget which preceded the introduction of the 1982 changes, it had been proposed that the provisions requiring imputation of interest income on loans to non-residents be amended to remove the exemption for loans to subsidiary controlled corporations. It was evident to tax practitioners, however, that this proposed change would not comprehensively address the issue of financing of foreign affiliates, and would, for example, have little impact on Canadian tax revenues in those situations where there was enough flexibility, having regard to foreign tax considerations, to restructure non-interest bearing debt (which would be subject to the imputed interest rules) into additional common or preferred share capital or contributed surplus (which would not). After further consideration by the Department of Finance, this proposed change was dropped. At the same time, however, it was announced that a study is underway which will review the entire Canadian approach to the taxation of foreign-source income. We accordingly may not have seen the last of this particular proposed change.[21]

C. New concept of excluded property

As discussed above at III.A., a resident of Canada may realize a taxable capital gain when selling shares of a

17. It may, however, be appropriate to also elect in respect of taxable surplus in certain situations, provided the affiliate whose shares are being disposed of has sufficient underlying tax.
18. For a more detailed review of those of the 1982 changes affecting foreign affiliates, the reader is referred to N. Boidman, "The Foreign Affiliate System: Canadian Taxation After 1982 – A Structured Overview" (CCH Canadian Limited), and to the joint paper by R.J. Dart, J.H. Meek, V. Peters and R.S. Wilson, 1982 Conference Report, Canadian Tax Foundation.
19. A "subsidiary controlled corporation" means a corporation more than 50% of the issued shares of which (having full voting rights under all circumstances) belongs to the corporation to which it is subsidiary.
20. The rules are also non-applicable where the loan remains outstanding for less than one year, or where the principal balance of the loan has itself been subject to Canadian tax.
21. For a detailed analysis of this subject, see V. Peters, "The Role of Section 17 in the Taxation of Foreign Source Income – Past, Present, and Future", *Canadian Tax Journal*, July/August 1982, p. 501.

foreign affiliate, and, similarly, a controlled foreign affiliate may realize FAPI (one half of any capital gain) when selling shares of another foreign affiliate. In both cases, an election is available under subsection 93(1), ITA to convert what would otherwise be proceeds of disposition for capital gains purposes into deemed dividends. These elections are often not sufficient, however, to fully eliminate any taxable capital gain or FAPI and, in addition, may only be made by Canadian corporations and not individuals.

The 1982 changes have introduced a new concept of "excluded property" and, under these provisions, where shares of a foreign affiliate qualify as excluded property, any capital gain or loss realized after 12 November 1981 on a disposition of those shares by another foreign affiliate will be automatically exempt from the FAPI provisions, without the requirement for filing an election under subsection 93(1) referred to above.[22] This exclusion from FAPI will apply in respect of both Canadian corporate and individual shareholders, and is perhaps the most significant of the 1982 changes to the foreign affiliate rules. The concept of excluded property has, however, been restricted to the FAPI provisions, and will not apply in respect of capital gains realized by a Canadian taxpayer on the disposition of directly-held foreign affiliates (although under the former election procedures under subsection 93(1), ITA will continue to be available to Canadian corporations in these circumstances).

Excluded property is defined to include shares of a foreign affiliate (whether in treaty or non-treaty countries), where all or substantially all of its assets are used principally in an active business. Certain planning steps may be required to meet the "all or substantially all" test in certain situations. For instance, if an affiliate has generated a balance of funds which are in excess of its normal working capital requirements and which are being used to earn investment rather than business income, it may be necessary to remove the excess assets from the affiliate in some manner prior to the disposition of its shares by another foreign affiliate.

In the past there were certain benefits which could be obtained where a Canadian shareholder used a foreign holding company to hold all of its interests in foreign affiliates. Having regard to the new excluded property provisions, and to the fact that these provisions are not applicable to capital gains realized on dispositions of directly-held affiliates, it will now be more important than ever to use a foreign holding company in most circumstances. In existing situations where a foreign holding company is not in place, Canadian taxpayers should consider reorganizing their foreign affiliate structure through a holding company incorporated and resident outside Canada, and the transfer of the shares of the various operating affiliates to the holding company. This type of reorganization can normally be done on a basis which will not attract immediate Canadian tax, provided the consideration received by the Canadian taxpayer includes shares of the holding company. However, the 1982 changes have blocked the ability to reorganize a foreign affiliate structure in this manner in most situations if the reorganization is done in contemplation of a sale by the holding company to a non-related person of the shares being transferred.

D. Foreign exchange gains and losses

In the past, gains or losses realized by a controlled foreign affiliate on the repayment of debt may have been relevant for purposes of the FAPI provisions, if the debt was considered to be of a capital nature. FAPI must generally be computed using Canadian currency, and it was therefore possible to realize "phantom" gains or losses related to foreign exchange in these types of situations. For example, consider a foreign affiliate carrying on business in the Netherlands which takes out a large guilder loan with a non-related party to finance a major capital acquisition, and which subsequently repays the loan. If the Canadian dollar has strengthened in relation to the guilder during the period the loans was outstanding, it was arguable that a taxable capital gain relevant for FAPI would be realized, based on the change in the value of the Canadian dollar relative to the guilder from the time the loan was taken out to the time it was repaid. This FAPI might arise notwithstanding that no economic gain (in terms of guilders) was actually realized by the affiliate in the Netherlands.

The 1982 changes have not provided that any gain or loss of a foreign affiliate from the settlement of a debt will be deemed to be a gain or loss from the disposition of excluded property (and thereby exempted from the FAPI provisions), provided the debt related at all times to the acquisition of excluded property. Excluded property includes assets used directly in an active business, as well as qualifying shares of other foreign affiliates (discussed above at III.C.), and loans used to finance the acquisition of either of the foregoing will therefore benefit from the new exemption. There should also be no adjustment to foreign affiliate exempt or taxable surplus accounts resulting from these types of gains or losses in future.

In situations where an affiliate borrows in the currency of a third country (for instance, an affiliate resident in the Netherlands borrows U.S. dollars), any foreign exchange gain or loss (in this case computed with reference to the change in the value of the Canadian dollar relative to the U.S. dollar during the period) would again be exempted from the FAPI provisions, provided the proceeds of the loan were used to acquire excluded property. However, it appears that a parallel computation is required for purposes of surplus account computations, and that the full amount of any foreign gain or loss (computed in guilders in our example, and measured with reference to the change in the value of the guilder relative to the U.S. dollar during the period) will affect exempt surplus.[23]

The former rules provided that foreign exchange gains or

22. However, a deemed election under subsection 93(1) will be considered to have been made in these circumstances, thereby preserving any exempt or taxable surplus balances of the affiliate being disposed of in the hands of its former parent affiliate (subsection 93(1.1), ITA).

23. This is because para. 95(2)(f), ITA and Regulation 5907(5) would require any foreign exchange gain or loss in this example to be computed in Dutch guilders, and 100% of any gain or loss would then affect exempt surplus, under Regulations 5907(1)(b) and 5907(1)(f). While the matter is not entirely certain, it appears that this same result may obtain even if the debtor affiliate is carrying on business in a non-treaty country; see N. Boidman, note 18.

losses on repayment of inter-affiliate debt were exempted from the FAPI provisions, where those gains resulted from fluctuations in the value of a currency of a country other than Canada relative to the Canadian dollar. Similar rules exempted foreign exchange gains and losses related to fluctuations in the value of the Canadian dollar from the FAPI provisions in situations involving redemptions or cancellations of shares of foreign affiliates, or dispositions of shares of foreign affiliates to persons related to the Canadian taxpayer. These exemptions, together with the new exemption for gains or losses on third party debt used to acquire excluded property, will eliminate a substantial portion of any FAPI concerns related to foreign exchange issues.

E. Loss portability and consolidated returns

As noted previously, a resident of Canada who owns shares of a controlled foreign affiliate is taxable on his pro-rata share of any passive income (FAPI) of the affiliate on an attribution basis, but is also entitled to deductions related to any underlying foreign taxes (termed "foreign accrual tax") applicable to the FAPI. Possible technical difficulties may arise in establishing foreign accrual tax, however, in situations where one foreign affiliate is entitled to deduct a loss of another in determining its own tax liability (such as under the U.K. group relief system), or where foreign affiliates file on a consolidated basis (such as in the U.S.).

For example, assume that a particular foreign affiliate resident in the U.K. has profits of £500,000 which are considered to constitute FAPI for Canadian tax purposes and that, in computing its U.K. tax liability, it deducts a £500,000 operating loss of another group company. Inasmuch as the affiliate which earned the FAPI would have paid no U.K. taxes, there appeared to be no deductible U.K. tax which could be established under the former rules. The 1982 changes will now provide that any amount paid to another foreign affiliate for the use of its losses in this type of situation will be deemed to be foreign accrual tax relevant for FAPI, provided the payment may reasonably be regarded as being a respect of income or profits taxes that would otherwise have been payable. Similar rules will be provided to establish foreign accrual tax in other foreign jurisdictions (such as the U.S.) where foreign affiliates file on a consolidated basis.

In addition, provisions will be introduced to provide more specific rules for the allocation of foreign taxes to exempt and taxable surplus accounts of the various affiliates in the above types of situations.

F. Reorganizations

Under the former rules, there were a number of provisions whereby foreign affiliate structures could be reorganized without any immediate taxation to the Canadian shareholder, either in respect of direct capital gains taxes, or in respect of FAPI realized by controlled foreign affiliates. The 1982 changes have introduced various technical amendments in this area, some of which are relieving and some of which are restrictive.

One change is that it will no longer be possible in most situations for a Canadian taxpayer to transfer shares of a foreign affiliate to a foreign holding company without recognizing capital gain for Canadian tax purposes, where the transfer is done in contemplation of a sale of the shares by the holding company to a non-related person. Also, various other changes have been introduced which are directed towards mergers and liquidations of foreign affiliates and foreign corporations. All of these changes are applicable to transactions occurring after 12 November 1981, and taxpayers should review any reorganizations which have taken place since the date in the context of the 1982 changes.

G. Repatriation of foreign affiliates

Foreign affiliates which became residents of Canada in the past would often find that significant benefits could be realized. For instance, while the payment of taxable surplus dividends to Canada by a foreign affiliate would normally have resulted in the imposition of substantial Canadian tax,[24] the taxable surplus of a foreign affiliate which had established residence was not a transaction which triggered any Canadian tax consequences. Dividend payments by the former foreign affiliate (now a resident of Canada) to a Canadian corporate shareholder would then be taxed in accordance with the normal rules governing inter-corporate dividends between corporations resident in Canada, and as such would generally not have been subject to Canadian tax.[25]

The 1982 changes will eliminate the above potential benefit, and in fact will result in significant and immediate Canadian tax cost in many situations where foreign affiliates become resident in Canada after 12 November 1981. The rules will now provide that any balance of taxable surplus in the affiliate at the time it becomes a resident of Canada will become immediately taxable to its Canadian corporate shareholder.[26] In addition, a foreign affiliate taking up residence in Canada will be deemed to have disposed of all of its capital properties at the time of the move, with resulting FAPI implications to its Canadian shareholders (both individuals and corporations).[27] These rules will apply even in situations where the foreign affiliate was not a controlled foreign affiliate at the time of the change of residency.

Having regard to the above provisions, it will be critical that foreign affiliates do not inadvertently become resi-

24. The amount of Canadian tax on dividends from taxable surplus will be dependent on the total foreign tax burden, including underlying foreign profits tax on the earnings being distributed as well as foreign withholding taxes applying on payment of the dividends.

25. As the former foreign affiliate, although resident in Canada and as such taxable on its world income, would normally not qualify as a "taxable Canadian corporation", an inter-corporate dividend paid after Canadian residentization would only be exempt to the recipient if the payor was controlled at the time of the subsequent dividend (subsection 112(1), ITA).

26. In many situations, taxable surplus will also arise by virtue of a deemed disposition of any property owned by the affiliate at the time of establishing Canadian residence which would otherwise be "excluded property". This additional balance of taxable surplus would also become immediately taxable to a Canadian corporate shareholder.

27. The deemed disposition of capital properties will not, however, apply to properties which would otherwise be "taxable Canadian properties", described in paras. 48(1)(a) and 48(1)(c), ITA.

dents of Canada in future. A foreign affiliate will normally be considered a non-resident of Canada if a majority of its directors are non-residents and all directors' meetings are held outside Canada. However, one should also ensure that the day-to-day business operations of the affiliate are managed and controlled outside Canada.

H. Special 25% tax on dividend income

Corporations resident in Canada are generally not subject to ordinary taxation on any dividends received from other Canadian corporations or, as previously discussed, on dividends from exempt or pre-acquisition surplus of a foreign affiliate. However, under the former rules, a corporation which was classified as a Canadian "private corporation"[28] might be subject to a special 25% refundable tax on such dividends under Part IV, ITA. The Part IV refundable tax is conceptually an advance tax paid by the private corporation on behalf of its ultimate individual shareholders, and is refunded to the Canadian corporation when it distributes the income in the form of taxable dividends to its own shareholders. This liability for Part IV tax might also apply to a private corporation in respect of certain deductions applicable to dividends received out of taxable surplus of a foreign affiliate. There were certain situations in which this special tax would not apply, and in respect of dividends from foreign affiliates, no tax was payable if the private corporation controlled to payor-foreign affiliate.[29]

The 1982 changes have amended the Part IV provisions so that, in certain circumstances, they will now also apply to Canadian corporations which are not private corporations.[30] However, a further change is that, in situations where the Canadian corporation does not control a foreign affiliate, exemption from the tax will nonetheless apply if the corporation owns more than 10% (votes and value) of all shares of the affiliate.

The potential liability for the special 25% tax has therefore been eliminated in most situations in respect of dividends from foreign affiliates, although there may be certain situations in which the tax may continue to apply, such as where a Canadian shareholder owns exactly 10% of a foreign affiliate.

I. Other changes

The 1982 changes include various other amendments to the foreign affiliate rules, and a detailed review of all of these changes is beyond the scope of this article. While not an exhaustive list, other changes to the foreign provisions are in the following areas:

- The deadline for filing of elections under subsection 93(1), ITA has been extended to 30 June 1983 in all cases where elections should have been filed in the past, or, in accordance with the existing provision which allows for late filing for up to 2 years, to 30 June 1985 provided a prescribed late filing penalty (maximum $2,500) is paid.
- The existing FAPI provisions provide that income earned by a controlled foreign affiliate for services may be deemed to be passive income relevant for FAPI, where the amount paid in consideration for the services is deductible in computing Canadian business income by the ultimate Canadian shareholder or by a related person. These provisions will be amended to ensure that they apply to back-to-back situations involving payments through third parties (such as re-insurance with captive insurance companies).
- In certain situations, the income of a non-resident trust may be subject to Canadian taxation under the FAPI provisions. The 1982 changes extend the application of these provisions in certain circumstances where an interest in a non-resident trust is acquired by a beneficiary by way of purchase, gift, bequest or inheritance, or by the exercise of a power of appointment of certain persons.
- Technical changes will be made to the definition of "deductible loss" in Regulation 5903, whereby FAPI of a controlled foreign affiliate may be reduced by deductible losses of the year and of the 5 immediately preceding years. One change is that the impact of active business earnings will now be restricted to reducing deductible losses which might otherwise be created through active business losses, and such earnings will not erode additional deductible losses which may arise from investment activities. Another change is that the deductible loss position will flow through on certain foreign mergers and dissolutions.
- In the past, there was some uncertainty as to the rules to be followed in determining the tax cost to a foreign affiliate of an interest in a partnership. Specific rules will now be provided in this regard.
- Changes will be made to the rules which allow a taxpayer to elect to receive more than a pro-rata portion of underlying foreign tax on dividends paid out of taxable surplus of a foreign affiliate (other than deemed dividends under subsection 93(1), ITA), whether received by the ultimate Canadian shareholder or by another foreign affiliate. Previously, this election was limited to situations in which the payor affiliate had no more than one class of shares outstanding, and will not be extended to situations where the payor has only one shareholder notwithstanding that it may have more than one class of issued shares.
- In the past, where a foreign affiliate disposed of capital properties used principally in an active business carried on in a non-treaty country, the full amount of the capital gain or loss formed part of exempt surplus. For dispositions of property after 12 November 1981, the Regulations will now provide that exempt and taxable surplus will each be affected to the extent of 50% of any capital gains or losses in these situations.
- More specific rules will be provided in prescribing

28. See note 8.
29. Control for this purpose is defined in subsection 186(2), ITA.
30. The Part IV tax will now also apply to any corporation resident in Canada which is not a private corporation, if it is controlled directly or indirectly in any manner whatever by or for the benefit of an individual or a related group of individuals.

the currency to be used in computing surplus accounts in respect of capital gains and losses realized by foreign affiliates.

- Various amendments have been made to the foreign affiliate Regulations (Regulation 5905) which require adjustment to surplus accounts in various reorganization situations, as well as in situations where a corporation resident in Canada or a foreign affiliate acquires shares or additional shares of another foreign affiliate, a foreign affiliate redeems or cancels any of its shares, a foreign affiliate issues shares, or an election is made under subsection 93(1), ITA. The 1982 changes introduce such concepts as "surplus entitlement", "surplus entitlement percentage", and "specified adjustment factor", and are fairly lengthy and complex. As presently drafted, the changes to the Regulations may produce anomalous results in certain situations, although they do represent a significant improvement over the corresponding rules in the former Regulations.
- A transitional provision is provided whereby a taxpayer resident in Canada may elect in its return of income for the 1982 or 1983 taxation year that various specific rules will apply in respect of taxation years of foreign affiliates ending after 31 December 1975 and commencing before 27 February 1980. This provision covers various types of situations and, while the matter is not entirely clear, it appears that, by electing, a taxpayer may be electing into all of the various transitional rules. A second transitional election, also to be made in the return of income for the 1982 or 1983 taxation year, provides various rules for situations in which elections have been made under Regulation 5907(2.1) (adjustment of surplus accounts for differences between book and tax depreciation of foreign affiliates in treaty countries).

IV. CONCLUDING COMMENTS

As the reader will no doubt have noted from the above, the 1982 changes to the Canadian taxation of international income have been largely directed towards the foreign affiliate rules. These particular rules are amongst the most complex in the Canadian tax legislation, and the recent changes have, if anything, exacerbated this complexity. While there are significant tax benefits to be achieved through the foreign affiliate system by the careful tax planner, there are also many pitfalls and traps for the unwary.

As mentioned above, there may be additional and significant changes forthcoming. The Canadian Department of Finance has indicated that a study is underway which will review the whole Canadian approach to the taxation of foreign-source income, and developments in this area will be watched by Canadian tax practitioners with great interest.

Conference Diary

MAY 1983

Institute for International Research: The Zürich International Corporate Finance Conference 1983 (including: taxation of currency transactions; tax impact on international and double taxed financing). Zürich (Switzerland), May 9-11 (English).

International Tax Planning Association: Ninth Annual Conference (including: the place of Belgium in international tax planning; the U.K.'s new anti-avoidance legislation; tax havens, new and old; interpretation of tax treaties; the French wealth tax: a new trend?; new direction in international tax planning). Brussels (Belgium), May 18-20 (English).

JUNE 1983

Management Centre Europe: Leasing in the 80's (including: crossborder leasing - legal and tax considerations). Brussels (Belgium), June 6-8 (English).

Management Centre Europe: Taxation of International Group Companies and Branches (including: taxation of branches; taxation of subsidiaries; taxation of shareholders; taxation of foreign currency gains and losses; domestic and tax treaty "anti-avoidance" measures). Brussels (Belgium), June 20-21 (English).

Management Centre Europe: International Cash Management (including: role of international tax planning in tax management). Nice (France), June 22-24 (English).

JULY 1983

Asian-Pacific Tax & Investment Research Centre: First Asian-Pacific Tax Conference. (Shangri-La Hotel) Singapore (Republic of Singapore), July 19-20 (English).

OCTOBER 1983

British Branch I.F.A.: U.S./U.K. Seminar. London (United Kingdom), October 6-7 (English).

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 9-14 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre: 2, Nassim Road, Singapore 1025, tel. 235-1959. Telex rs 50257 aptirc (Republic of Singapore).

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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

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

Institute for International Research: 57/61 Mortimer Street, London W1N 7TD (United Kingdom).

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

U.S.A. Branch of I.F.A.: D.R. Tillinghast c/o Hughes, Hubbard & Reed, One Wall Street, Suite 2600, New York – NY 10005 (U.S.A.).

UNITED KINGDOM:

Budget 1983-84

Family – Enterprise – Recovery

Extracts from the Budget Speech pronounced by Sir Geoffrey Howe, Chancellor of the Exchequer, on 15 March 1983.

A discussion of the U.K. Budget will appear in the International Bureau of Fiscal Documentation's tax journal: *European Taxation.*

. . .

I have also had to consider the implications of the recent fall in North Sea and other oil prices. Of course, lower oil prices reduce the value of our own oil production. But North Sea oil accounts for only 5% of our national income, and tax on it for only some 6% of Government revenues. Moreover, the health of a much larger part of our national economy depends on the state of the world economy.

Though sharp swings in the oil price are in nobody's interest, moderate reductions mean lower inflation abroad, and lower prices here. The fall in the general level of world oil prices is therefore to be welcomed. A more prosperous world will in time mean more output and jobs in Britain.

It follows from this that it would be unnecessary, as well as impractical to react to every deviation in the oil market by changing the general level of taxes. The forecast published in the Red Book reflects the prices currently offered by BNOC to North Sea producers. Clearly there could be a change in oil prices sufficient to affect the balance of revenue and expenditure in the Budget, though not all the effects would be one way.

There is no simple arithmetical guide for dealing with this, let alone allowing for it in advance. Much would depend on the extent of the change and the attendant circumstances. If any further reduction in oil prices seemed likely to compromise the success of our economic strategy I would be ready to take appropriate corrective action. But the lesson for today is that it is prudent to keep planned borrowing down.

Taking these factors into account, I have decided to hold to the previous plan, and provide for a PSBR in 1983-84 of 2¾% of GDP, that is some £8bn.

. . .

CHARITIES

Once again we have been pressed to reimburse charities for VAT on their taxable purchases. But, however, exhaustively and sympathetically we examine this proposal, the difficulties remain and cannot be swept aside. I have been able in previous years to extend VAT reliefs for the disabled and charities serving them. But a VAT refund scheme would be expensive to operate and indiscriminate in its effects, benefiting not only those charities which do valuable work in the community but also – and sometimes disproportionately so – many other bodies with very limited or controversial aims which do not command public support. So as before, I have been forced to conclude that we are right to channel our help in other ways.

But I do intend to give some extra help. In 1980 I introduced substantial new tax relief for covenanted donations to charities by allowing relief against higher rates of income tax up to a ceiling of £3,000 a year; and last year I increased the limit on exemption from capital transfer tax for gifts made within a year of death from £200,000 to £250,000.

I propose now to carry these two measures further by raising to £5,000 the ceiling on higher rate relief for gifts made by deed of covenant and by abolishing the ceiling on exemption from capital transfer tax for charitable bequests. All outright gifts and bequests to charities will now be entirely free from CTT.

I have had representations about the position of companies which would like to second their staff with pay to charities. At present the employee's salary is not allowable for tax because it is not an expense incurred by the company wholly and exclusively for the purpose of its business. For normal business expenses we must continue to stick to that general principle. But I am satisfied that it is right to make an exception in this limited case. Companies which lend staff to work for charities and continue to pay their salaries will now be able to treat the cost as an allowable expense for tax purposes.

CONSTRUCTION INDUSTRY

I come now to housing and the construction industry. The whole House is anxious to see more activity in this sector. Within the public expenditure plans there is provision for capital expenditure on construction in 1983-84 of over £10bn, a 10% increase on this year's expected outturn. We want this money used effectively for the purpose for which it is intended.

One of our highest priorities has always been the extension of home-ownership. This Government has done more than any other to encourage this. Since we came to office almost half a million public sector tenants have bought their homes; and the fall in mortgage rates over the past year has made it easier for first-time buyers to meet the costs of a mortgage.

But it is now clear that the £25,000 limit on mortgage interest tax relief is beginning to hinder a growing number of families who want to buy their first home or to move. I have therefore decided to increase the limit to £30,000. This will cost some £50m in 1983-84: it will help potential homeowners and the construction industry alike.

At the same time I intend to remove an anomaly whereby a borrower may get tax relief in excess of the ceiling for both an ordinary mortgage and an interest-free loan from his employer.

I also propose to extend mortgage interest relief of the kind already enjoyed by many employees, whose duties prevent them living in their own homes, to self-employed people, like tenant farmers and tenant licensees, who have a contractual requirement to live in accommodation provided for them but who are also buying their own homes. This will be accompanied by a similar extension of the capital gains tax relief applying to a private residence.

We want to help people not only to own their own homes but also to keep them in good repair. Last year I announced a major attack on disrepair by increasing the rates of repairs grants. This has proved very successful. Expenditure in 1982-83 will be twice that in 1981-82 and a further increase is expected next year.

We have already announced that the higher rates are to continue until the end of 1983-84. And local authorities have been told they may spend without limit on all improvement grants next year. To ensure that we get the greatest impact from this initiative, the limits on expenditure eligible for grant will be increased by 20%.

Our main aim, of course, is to help people to themselves. But there are some areas, particularly in the inner cities, where decay in the private housing stock is so bad that concerted action is needed. We are encouraging local authorities to tackle such areas by the process known as enveloping – where the authority repairs the external fabric of whole terraces or streets of houses on behalf of the owners. This has proved a cost-effective way of improving an area, and we will be allowing local authorities to undertake additional expenditure in 1983-84 on any approved enveloping scheme.

These two measures are likely to lead to additional expenditure of some £60m in 1983-84. In addition my Right Honourable Friend the Secretary of State for the Environment is today announcing further measures to encourage local authorities to make full use of the resources available to them for capital investment.

Today I can announce three further steps to help the construction industry.

First, in 1981 I introduced a scheme to defer Development Land Tax on developments for the owners' own use. The scheme, which is due to end in April 1984, has proved valuable, and I propose to extend it to April 1986, at a cost of £4m in a full year.

Secondly, stock relief will from today be available for houses accepted by builders in part exchange on the sale of a new house for the personal use of an individual or his family. This will cost £5m in a full year.

Third, I propose to increase from 10% to 25% the proportion of office space in buildings qualifying for the industrial buildings allowance – an allowance which I increased in 1981. The cost will be about £25m in a full year.

NO CHANGE OF VAT RATE

I come now to the indirect taxes.
I propose no change in the present rate of VAT.

EXCISE DUTIES: ALCOHOL AND TOBACCO

In successive Budgets I have sought to establish the sensible presumption that the excise duties should be adjusted broadly in line with the movement of prices from one year to the next. This is essential if we are to maintain the right balance between direct and indirect taxes.

This year too I intend to follow the same approach. But our succes in reducing inflation means that the increases I shall be announcing will be much smaller than in recent years. The additional revenue I shall be seeking from duty changes this year is about half of the comparable figure in 1980 and 1982 and about a quarter of that in 1981.

I start with the duties on alcoholic drinks. I propose to increase the duties from midnight tonight by amounts which represent, including VAT, about 25p on a bottle of spirits, 5p on a bottle of table wine, 7p on a bottle of sherry and 1p on the price of a typical pint of beer. On cider, which is increasingly competing with beer, I propose a similar increase of 1p a pint.

As for tobacco, I propose to increase the duty by the equivalent including VAT of 3p on the price of a packet of 20 cigarettes. There will be consequential increases for cigars and hand-rolling tobacco, but no increase for pipe tobacco. These changes will take effect from midnight, Thursday.

OIL AND CARS

Next, the oil duties. I am conscious of the concern felt by a number of my Honourable Friends about the effect of increases in duties on petrol and derv. But at a time when world oil prices are falling it would not be right to allow the real value of the duties to be eroded significantly. I propose therefore to increase the duty on petrol by about 4p a gallon, including VAT. In the case of derv I propose an increase, including VAT, of about 3p a gallon. These changes will take effect for oil delivered from refineries and warehouses from 6 p.m. tonight.

As in the last two years I propose no change in the rate of duty on heavy fuel oil. The real burden of this duty will thus have been reduced since 1980 by some 20%. This will be of considerable continuing assistance to industry, since it will help to hold down its energy costs.

I also propose a number of changes in the rate of vehicle excise duty. For cars and light vans the duty will be increased by £5 from £80 to £85. On goods vehicles, the new duty structure introduced last year allows me to spread the burden more fairly.

In order to bring the rates of duty more nearly into line with the costs the various categories of lorry impose on the road system, I propose to increase the duty on some 190,000 heavy vehicles. This means that I shall, on the same lines, be able to reduce by approximately 10% the rates of duty on some 315,000 lighter commercial vehicles. These changes will take effect from tomorrow.

The total effect of all the changes in excise duties will be to raise additional revenue of some £600m a year. But let me emphasise again that this implies virtually no change in the real burden of indirect taxes in 1983-84. The immediate effect will be to add about 0.4% to the overal level of prices. This has been taken fully into account in the price forecasts which I have given to the House.

NORTH SEA TAX

I come now to North Sea tax. The development of the North Sea is a notable achievement of private enterprise and the result of a huge co-operative effort involving hundreds of companies and thousands of people. We want this to continue into the future, despite changes in oilfield economics. Tax is not the only factor in sustaining North Sea potential. Steps taken by the industry to cut costs and the future level of oil prices will be at least as important. But the tax structure must adapt as well.

I am therefore proposing a substantially more favourable regime to assist the companies as they move on to develop new fields and, in order to help finance new activity, a package of relief on current fields. The industry will benefit from these changes by more than £800m over the next four years, starting with £115m in 1983-84.

To encourage further exploration and appraisal, I propose immediate relief against petroleum revenue tax for expenditure incurred after today in searching for oil and appraising discovered reserves.

For future fields I propose two important new incentives. First, the oil allowance, which is the quantity of oil production exempted from PRT, will be doubled for such fields.

Second, my Rt Hon Friend the Secretary of State for Energy will be taking steps to abolish royalties for these fields. The changes will apply to future fields where development consent has been given on or after 1 April 1982, with the exception of the relatively more profitable Southern Basin and onshore fields, I am ready to discuss with the industry whether there is a need to extend these incentives to the Southern Basin fields. If I were to be persuaded of the need, any extension would be backdated to development consents issued after today.

Most existing fields make good profits. But to improve current cash flow, I have decided progressively to phase out Advance Petroleum Revenue Tax. As a start, the 20% rate will be reduced to 15% from 1 July, and APRT will disappear completely by the end of 1986.

An Inland Revenue press release will give further details, and also describe other proposed changes in oil taxation. They include, following the consultative document published last May, proposals on PRT reliefs for expenditure on shared assets such as pipelines, and for charging related receipts.

The proposals will give significant additional relief on expenditure and will exempt tariffs on half a million tonnes of oil a year from each field using a pipeline. This will encourage the shared use of these assets.

I believe that my proposals will provide the industry with the right fiscal incentives for the further successful development of the country's North Sea resources.

BUSINESS AND INDUSTRY

From one key industry I turn now to business and industry as a whole. Our living standards and jobs depend on our ability to sell and compete, producing the right goods and services at the right time and the right price. The main responsibility for archieving this lies with industry and commerce. But government can help by reducing the burdens it places on business.

These can be twofold. High inflation and excessive public borrowing have in the past kept interest rates and business costs higher than they need have been. We have made progress in putting that right. But government also imposes direct burdens on business, and here too we have acted to help cut costs. I have given high priority to reducing the National Insurance Surcharge (NIS), the tax on jobs first introduced and then increased by our Labour predecessors.

In last year's Budget I cut NIS from 3½% to 2½%. In November I announced that, for 1983-84, the rate would be further cut to 1½%. On top of this I made special arrangements to enable half of that further cut of 1% to be brought forward into 1982-83.

I now propose that the rate be reduced from 1½% to 1% from August 1983. As before the benefits will be confined to the private sector. This cut is worth another £215m in 1983-84 and nearly £400m in a full year.

The surcharge was 3½% when this Government took office. We are now well on the way to abolishing it. The reduction from 3½% to 1% will be worth nearly £2bn to private business in a full year.

CORPORATION TAX

On corporation tax, we issued a Green Paper over a year ago. I am grateful for the many thoughtful responses, which we have examined carefully. There is one impression that stands out.

That is the overwhelming desire on the part of industry for stability in the corporation tax regime. I recognise the force in this. Change is not costless. I have therefore concluded that there should be no change in the broad structure of the present arrangements. As regards the taxation of inflationary profits, I await the outcome of the accountancy profession's further considerations.

There are, however, some useful changes on which I can make a start today.

At present, advance corporation tax can be carried back two years to be set against corporation tax. I propose to extend this over a period to six years. I also propose that the incidental business costs of issuing acceptance credits and of issuing certain convertible loan stocks should be allowable expenses for corporation tax purposes.

There are other areas where we need to make progress, including the tax treatment of groups and capital allowances for the mineral extraction industries. I am authorising the Inland Revenue to look further at these issues, and to consult on them where necessary.

INTERNATIONAL BUSINESS

On the taxation of international business, I have considered carefully the responses to the latest round of consultation. I have decided not to proceed this year with measures concerning company residence and upstream loans. Both need further consideration.

On tax havens, however, I propose to move clauses which take account of the recent consultations. These will not come into effect until April 1984.

This change should be considered alongside one other proposal that flows from the Corporation Tax Green Paper. At present, credit for foreign tax on overseas income is only allowed against such of a company's corporation tax liability as remains after deduction of ACT (see also page 183).

As a result of representations received in response to the Green Paper, I propose that from April 1984 this double tax relief should be allowed against the full corporation tax liability before ACT is deducted.

As I have said, my proposals on tax havens and on AST and double tax relief have to be seen together. Between them, they will not involve any increase in the total burden of tax on international business. But they do mean a switch in the tax burden away from those who remit profits home and on to those who accumulate surplus cash balances in tax havens overseas. I am sure the House will agree that this is right.

COMPANY CARS, FRINGE BENEFITS, ETC.

To turn to a different area, I announce each year the future scale rates for measuring the benefits from company cars. Recent increases have been at a rate of 20%, but the levels still fall short of any objective measures of the true benefit.

This year, I am proposing further increases with effect from April 1984; but they will be held to about 15%. These increases will also apply from the same date to the new car fuel scales which come into operation next month.

I have also decided to legislate to bring back into tax the benefit from scholarships provided by employers for the children of their higher paid employees. There will be a transitional exemption for awards made before today so that scholarship income in respect of an existing award will continue to be exempt until the child leaves his present school or college.

I propose too to remove an anomaly by which some people have their tax bills artificially reduced because their employers do not account for PAYE at the right time and then pay too little. I also propose with effect from April 1984 to increase substantially the tax measure of the benefit gained by an employee who occupies rent-free, or at a very low rent, expensive accommodation owned by his employer.

The House will be aware of instances of tax avoidance through the exploitation of group relief, and through the exploitation of so-called second-hand bonds. I propose legislation to deal with these abuses and also to improve the arrangements for collecting DLT on disposals by non-residents.

BANKS

And now a word about banks. I said last year that we would be giving further thought to the problem of how best to ensure a sufficient contribution to tax revenues by the banking sector.

I have examined the position with great care in the light of current circumstances, and have concluded that it would not this year be sensible to tighten the tax regime for banks.

SMALL AND MEDIUM-SIZED COMPANIES

Finally for the company sector, I propose some changes that are designed specifically to help small and medium-sized companies. At present the so-called small companies rate of corporation tax is 40% and applies to taxable profits up to £90,000. The 52% rate is payable at £225,000. I propose to reduce the 40% rate to 38%, to raise the lower limit of £90,000 to £100,000 and to raise the upper limit from £225,000 to £500,000.

Between these two limits profits are subject to a marginal rate which stood at just over 66% when this Government came into office. I have already reduced it to 60%. The changes that I am proposing today will bring it down to 55½% – only a little above the main 52% rate.

These changes will concentrate the help that I can give on the many small and medium-sized companies with taxable profits of up to £½m. The cost will be £40m in 1983-84 and £70m in a full year.

Small and medium-sized enterprises are a major source of new wealth for the nation and, above all of new jobs. I shall, therefore, propose today a further series of measures which will foster their growth, greatly extending those which I have already introduced and whose results are already evident.

I am told that Britain now offers a more attractive tax environment than Germany for venture capital and for the micro - electronics revolution. That was not so five years ago. I now propose further action in a number of areas.

EMPLOYEE SHARING SCHEMES

I want more people to share in the ownership of the companies for which they work. It is both a good incentive and a good way for people to build up a capital stake. The measures so far introduced have already brought us to the position where about a quarter of a million employees receive shares each year.

But I want to make these employee profit sharing schemes more attractive and more flexible, while still open to all employees. Already companies can give tax-free shares to employees each year up to the value of £1,250. I propose to add an alternative limit of 10% of the employee's earnings, up to a maximum of £5,000.

This new freedom will provide still further encouragement to management upon whom so much depends.

Share options for senior managers also provide an important incentive. Last year I introduced arrangements to spread the income tax burden that can arise when an option is exercised. I propose this year to increase the instalment period from three years to five years.

Save As You Earn linked share option schemes already cover over 100,000 employees. The monthly limit on contributions with tax relief now stands at £50. In order to encourage further growth I propose increasing it to £75.

The total cost of all these share incentive measures will be £20m in 1983-84 and some £35m in a full year.

I also want to ease the path for employees of a company who seek to buy the business for which they work. The transformation that followed the employee buy-out of the National Freight Company shows how valuable this can be. In order to help those who borrowed to take part in this buy-out and to encourage similar success, I propose that where an employee-controlled company is being set up the employees should benefit from interest relief on loans they take out to buy shares in it.

CAPITAL TAXES

Capital taxes can suffocate enterprise. Last year we took the major step of indexing capital gains. It is clearly appropriate to provide a period of stability to let the new structure settle in.

We have already announced that administrative measures will be introduced to help large institutional investors. I now propose that, as the legislation provides, the annual exempt amounts for individuals and for trustees should be increased in line with inflation. And I propose to increase to £20,000 the limits on the relief for small part disposals of land and for residential letting.

I propose to double the present retirement relief, raising it to £100,000. This will further encourage entrepreneurs to keep money in their business where it can work to best effect. I have received a number of representations that other features of the present relief cause difficulty, and we shall therefore be conducting further consultations later this year.

The cost of the CGT measures I have announced will be £15m in a full year. There will be no cost in 1983-84.

On capital transfer tax, I propose to increase the threshold and rate bands broadly in line with indexation. As a result the threshold will rise from £55,000 to £60,000.

LOW TAX AREAS

After the Chancellor sat down the Inland Revenue released the following statement:

The Chancellor proposes in his Budget to enable a charge to corporation tax to be imposed on certain UK resident companies with interests in UK controlled companies resident in low tax countries. Legislation, which will take effect from 6 April 1984, will be contained in this year's Finance Bill. The Chancellor does not propose to proceed this year with any measures on company residence or upstream loans.

These related issues were discussed in the consultative document "Taxation of International Business" published by the Inland Revenue in December 1982. The Chancellor's proposals have been formulated in the light of the response to that document.

The December 1982 consultative document proposed measures to counter the use of controlled foreign companies in low tax countries where avoidance of UK tax was the main, or one of the main, purposes of the activities.

It contained draft clauses which would enable a charge to corporation tax to be imposed on certain UK companies with at least a 10% interest in foreign companies under UK control but resident in a low tax country. Representations made on the draft clauses have been carefully considered and a number of changes will be made in response to them. Details of the changes will be announced at the time of publication of the Finance Bill.

The December 1982 document announced the Government's decision not to proceed with a statutory definition of company residence. It also stated that the Government intend to bring forward specific measures to deal with arrangements which take advantage of the current company residence rules.

In November 1981, the Inland Revenue published, in the consultative document "International Tax Avoidance," draft clauses designed to remove the tax advantages available where an overseas subsidiary remits profits to the U.K. in the form of a loan, instead of a dividend. In the light of the response to that document the Government deferred action to give the issue further consideration bearing in mind the need to distinguish and protect loans made in the ordinary course of business.

The legislation on controlled foreign companies which will be contained in the Finance Bill retains the definition of a "lower level of taxation" provided by clause 3 of the draft legislation published in the December 1982 consultative document "Taxation of International Business."

This means that an overseas company will be subject to a lower level of taxation if the tax paid in its country of residence on profits arising in an accounting period (the local tax) is less than one half of the notional U.K. tax (computed without credit for the local tax) that would have been payable for the accounting period had the company been resident in this country.

Once the legislation is enacted it is proposed to publish a list of countries which will not be regarded as "low tax" countries for this purpose. A final list cannot be prepared at this stage since it must depend on the details of the legislation as enacted. In any event it has not yet been possible to examine the relevant laws of all overseas countries which may appear on a final list.

But the Government have decided that subject to these necessary qualifications a provisional list (attached) should be made available now before the legislation is introduced. A definitive list will be published as soon as possible after the Finance Bill receives Royal Assent.

A company which is resident in and carrying on business in a country within Part 1 of the list given later would be excluded from the application of the proposed legislation. Where the country of residence appears in Part II the company would be similarly excluded provided it is not subject to any relief specified.

If a company is resident in a country not on the list or if it is entitled to one of the reliefs specified in Part II, it does not follow that a charge would be made in respect of it. In either case it would be necessary to consider whether the company is in fact subject to a lower level of taxation as defined in the legislation, and if so, whether any of the other statutory tests for exclusion (including the motive test) are satisfied.

Part I Countries not regarded as "low tax":

Algeria, Argentina, Australia, Austria, Bangladesh, Belgium, Belize, Botswana, Brazil, Brunei, Bulgaria, Burma, Cameroon, Canada, China, Czechoslovakia, Denmark, Dominica, Egypt, Ethiopia, Falkland Islands, Faroe Islands, Fiji, Finland, France, Gambia, German Democratic Republic, German Federal Republic, Ghana, Greece, Hungary, Iceland, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Japan, Jordan, Kenya, Republic of Korea, Lesotho, Libya, Malawi, Malaysia, Malta, Mauritius, Mexico, Morocco, Namibia (South West Africa), New Zealand, Nigeria, Norway, Pakistan, Peru, Philippines, Poland, Portugal, Romania, St. Kitts, St. Lucia, Saudi Arabia, Seychelles, Sierra Leone, South Africa, Soviet Union, Spain, Sri Lanka, Sudan, Swaziland, Sweden, Taiwan, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Uganda, U.S., Venezuela, Yugoslavia, Zaire, Zambia, Zimbabwe.

Part II Countries not regarded as "low tax", subject to qualifications stated:

Ireland: Companies obtaining relief or exemption from tax under Part V of the Corporation Tax Act 1976 or Section 43 of the Finance Act 1980 (profits from trading within Shannon Airport).

Luxembourg: Companies obtaining any special tax benefit under the law of 31 July 1929, decree of 17 December 1938, as amended or Grand Ducal Regulation of 29 July 1977 (holding companies).

Netherlands: Companies obtaining relief or exemption from tax under Article 13 of the Corporate Income Tax Law of 1969 (affiliation or substantial participation privilege).

Singapore: Companies subject to the concessionary rate of tax for insurance and reinsurance of risks outside Singapore by virtue of Section 43C of the Income Tax Act as amplified by the Income Tax (Concessionary Rate of Tax for Income from Insuring and Re-insuring Offshore Risks) Regulations 1980.

Also, companies subject to the concessionary rate of tax for specified Asian Currency Unit income by virtue of Section 43A of the Income Tax Act as amplified by the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations 1979.

I am concerned that the prospect of capital transfer tax may still discourage those who are contemplating investing capital in small businesses. It may also be one of the factors reducing the number of farms available for letting. I therefore propose to increase relief for minority shareholders in unquoted companies and for let agricultural land from 20% to 30%.

The cost of these changes in capital transfer tax will be £20m in 1983-84 and £55m in a full year. Other minor changes to CTT and CGT are set out in Inland Revenue Press notices.

I propose two other measures to help small firms. The VAT registration threshold will be increased with effect from midnight tonight from £17,000 to £18,000 at a cost of £5m in a full year.

And I propose to increase from £200 to £1,000 the de minimis limit for assessment of investment income apportioned to the members of a close company.

INNOVATION AND TECHNOLOGY

Now, innovation and technology. I have already announced an increase in the proportion of office space in buildings qualifying for the industrial buildings allowance.

This additional flexibility will be of particular value in the high technology industries, which often need relatively large amounts of space for design and computer-based activities. It will cost about £25m in a full year. On the tax side, I also propose to extend the 100% first-year allowance for rented teletext receivers until May 1984, and for British films until March 1987. The full year cost of these two measures will be £10m and £30m respectively.

SMALL WORKSHOPS

Last year, I extended the small workshop scheme by two years for very small industrial units. The scheme is proving very effective in promoting the provision of premises for new businesses.

This year I want to encourage the conversion of more old buildings into productive workshops: I propose to allow all such units in a single converted building to qualify for 100% first year allowances if on average they meet the size requirements.

DEEP DISCOUNT STOCK

Now I come to the important matter of finance for business, on which I have major improvements to propose.

Companies and monetary policy alike would both benefit from a revival of the corporate bond market. Lower long-term interest rates are the key to this. But there are also a number of ways of giving companies greater flexibility in the nature and timing of the bonds they issue.

A consultative document on deep discount stock was issued on 12 January. It set out a range of options. I am grateful to those who responded.

I now propose to introduce attractive tax arrangements for this stock. The borrower will get relief on an appropriate accruals basis, but the investor will pay tax only at redemption or on sale. There was considerable support for such tax treatment.

Companies will still be able to issue conventional or indexed bonds. My proposal extends their range of options.

I also propose certain reliefs to enable companies to issue Eurobonds in this country and to ensure that full tax relief is available for discounts paid on acceptance credits.

SIMPLIFICATION OF STAMP DUTY

We shall be issuing on 21 March a consultative document on the possibilities for the simplification of stamp duty.

...

FREEPORTS

On 3 March I informed the House about the publication of the report of the working party on freeports, under the chairmanship of my Hon Friend, the Economic Secretary to the Treasury. I can now tell the House that the Government accepts the report and will implement its recommendations. Legislation will therefore be introduced in the Finance Bill to enable selected freeport sites to be designated.

Freeports are a new trading concept for the U.K. and I regard it as essential to make a careful test of the facilities they offer. As the report recommended, therefore, the first step is to establish free ports on an experimental basis in a limited number of locations. Widespread consultation will be needed before the sites are chosen.

BUSINESS START-UP SCHEME

Last, but far from least the business start-up scheme. This scheme, announced in my 1981 Budget statement, offers uniquely generous tax incentives to outside investors in small companies. It is not bettered anywhere in the world. But I now intend to better it.

When I introduced the scheme I thought it right to give priority to investment in business start-ups, where there is often the greatest difficulty in raising outside equity finance.

I now propose a major extension of the scheme. It was due to end in April 1984. The life of the new, extended scheme will run to April 1987. From 6 April the coverage will be greatly widened, to include not only new companies, but qualifying established unquoted trading companies as well. I propose also to double the allowable maximum investment in any year from £20,000 to £40,000. A number of other changes will be made to improve the scheme. In particular the 50% limit on qualifying shares will be dropped. The cost of these changes is difficult to estimate, but could be £75m in a full year.

These proposals will transform the position of unquoted trading companies seeking outside equity. It is a further move towards removing the bias in the tax system against the personal shareholder, and a further measure to encourage wider share ownership. By concentrating help on those companies which do not have ready access to outside capital the scheme will assist many more small and medium companies to realise their undoubted potential for growth. The new, extended, scheme will be known as the Business Expansion Scheme.

COMPETITIVE CONDITIONS

Our constant concern as a government has been to improve the competitive environment for businesses and people who work in them. These proposals mark a further major step in that direction.

In judging the right balance to strike in this Budget I have taken into account the measures I announced in the autumn which will directly reduce business costs. I have also taken account of the lower level of the exchange rate. As I said in my Budget speech two years ago, exchange rate changes alter the distribution of income between companies and persons.

A higher exchange rate boosts personal spending power but it squeezes the profits of companies exposed to international competition. Consequently, in my 1981 Budget, personal income tax thresholds remained unchanged in order in part to be able to offer some help to companies.

The same consideration led me to direct over two-thirds of the real tax reductions in my 1982 Budget towards business and industry, in order to help cash flow and rebuild profits. In this Budget too the measures I have announced so far go largely in the same direction. Taken together with the net effect of the changes that I announced last autumn, they will provide help for business and industry that is worth around £1¼bn in a full year.

And that is less than half the story. For, if revenue from taxes paid by business - apart from the North Sea industries - were the same share of total taxes in 1983-84 as they were in 1978-79 then these businesses would have to pay some £3bn more than is forecast for the coming year.

But profits have fallen, and over the years I have acted deliberately to lighten that load. And I have done so in recognition of the case for helping business which has been strongly, and rightly, argued in debate after debate, and from all quarters of this House. I don't believe any Hon Member would suggest that business and industry should pay more tax.

But I have had to recoup the £3bn. And I have had to do this alongside the need both to hold down borrowing - not least to secure lower interest rates, and hence reduce business costs - and to finance public expenditure. Although spending is now being restrained, it is worth noting again that there are few Hon Members who have not called for increases, rather than cuts.

It is considerations of this kind which have led to the burden of tax on people, under successive Governments, becoming so unacceptably high. The House and the country must face this reality: spending at current levels which some still regard as too low, together with current levels of tax on business, which many regard as too high, have brought successive Governments to a position where there has been no alternative to high levels of tax on people.

But the fact is that reductions in personal taxation themselves help business and employment. Indeed, it is the individuals who work in business who largely determine business success.

Yet for years in Britain the tax system and the tax burden have discouraged individual effort, commitment and enterprise. By strengthening incentives through lower personal taxes, government can help increase the commitment to business success at every level. And when the State takes less of what people earn, there is less justification for excessive pay demands and settlements. Cuts in personal tax provide a vital stimulus for lasting growth and jobs.

Happily, because we are reining back public spending - though not yet far enough - the choice is less stark now than in the past. I am able to combine the significant measures of direct tax relief to industry and enterprises which I have just announced with a substantial measure of direct tax relief to people.

POVERTY AND UNEMPLOYMENT TRAPS

Acknowledged unfairnesses and anomalies produced by the overlap between the tax and social security systems give further compelling reasons to move in that direction. It makes no sense that people on low incomes should be paying tax at all. And low tax thresholds are of course an important part of the poverty and unemployment traps.

These traps mean that some of those out of work who could find a job, and some of those in work who could find a better one, do not do so because they would end up no better off, with all or more of their increase in income taken in tax and National Insurance contributions, or lost in benefits forgone.

This is a situation that demands reform. But those who claim to have found a quick, cheap way to dispose of the poverty and unemployment traps decieve themselves. The problem has grown up almost entirely because Governments for 30 years or more have increased benefits in line with earnings, but raised personal tax thresholds only in line with prices, which have grown much more slowly over the years.

In 1950, the tax threshold for a married man was about two-thirds of average earnings. Today it is barely more than one-third.

A situation that has built up over 30 years cannot be put right in one Budget or even one parliament. These problems have arisen, moreover, not because Government spends too little, but because successive Governments have spent and taxed too much.

The substantial increase which I have proposed in child benefit will improve work incentives for the low paid. And several of the measures we have taken since 1979 have reduced the unemployment trap. But it is only by limiting public spending, as we have done, that we can begin to get to grips with the problem along the lines I now propose.

Single person and married couples

Comparison with 1982-83 where earnings increase by 6.5% between 1982-83 and 1983-84

	Charge for 1982-83				*Proposed charge for 1983-84*			
Annual income in 1982/83 £	Income tax £	NIC† £	Percentage of total income taken in tax & NIC %	Adjusted* income in 1982/83 £	Income tax £	NIC† £	Percentage of total income taken in tax & NIC %	Percentage charge in income after tax & NIC %
				SINGLE PERSONS				
2,000	130	175	15.2	2,130	103	192	13.8	8.3
2,500	280	219	20.0	2,662	263	240	18.9	7.9
3,000	430	262	23.1	3,195	423	288	22.3	7.6
3,500	580	306	25.3	3,727	583	335	24.6	7.5
4,000	730	350	27.0	4,260	742	383	26.4	7.4
6,000	1,330	525	30.9	6,390	1,381	575	30.6	7.0
8,000	1,930	700	32.9	8,520	2,020	767	32.7	6.8
10,000	2,530	875	34.0	10,650	2,659	958	34.0	6.6
12,000	3,130	1,001	34.4	12,780	3,298	1,100	34.4	6.5
15,000	4,094	1,001	34.0	15,975	4,257	1,100	33.5	7.2
20,000	6,261	1,001	36.3	21,300	6,462	1,100	35.5	7.9
25,000	8,727	1,001	38.9	26,625	9,010	1,100	38.0	8.1
40,000	17,231	1,001	45.6	42,600	17,834	1,100	44.4	8.7
50,000	23,231	1,001	48.5	53,250	24,224	1,100	47.6	8.4
				MARRIED COUPLES #				
2,500	16	219	9.4	2,662	0	240	9.0	7.0
3,000	166	262	14.3	3,195	120	288	12.8	8.4
3,500	316	306	17.8	3,727	280	335	16.5	8.1
4,000	466	350	20.4	4,260	439	383	19.3	8.0
6,000	1,066	525	21.5	6,390	1,078	575	25.9	7.4
8,000	1,666	700	29.6	8,520	1,717	767	29.2	7.1
10,000	2,266	875	31.4	10,650	2,356	958	31.1	7.0
12,000	2,866	1,001	32.2	12,780	2,995	1,100	32.0	6.8
15,000	3,766	1,001	31.8	15,975	3,954	1,100	31.6	6.7
20,000	5,865	1,001	34.3	21,300	6,007	1,100	33.4	8.1
25,000	8,727	1,001	37.2	26,625	8,505	1,100	36.1	8.3
40,000	16,703	1,001	44.3	42,600	17,228	1,100	43.0	8.9
50,000	22,703	1,001	47.4	53,250	23,618	1,100	46.4	8.5

* The adjusted incomes shown for 1983-84 are for illustration. They have been obtained by increasing the corresponding incomes in 1982-83 by 6.5%.
† National Insurance Contributions are at the Class 1 standard rate for employment not contracted out of the State additional (earnings related) pension scheme.
\# Assuming that only the husband has earned income.

	Charge for 1982-83		*Proposed charge for 1983-84*		*Reduction in tax after proposed change*	
Income £	Income tax £	Percentage of total income taken in tax %	Income tax £	Percentage of taken in tax total income %	Income tax £	As percentage income of total %
			SINGLE PERSONS			
35,00	1,47	4.2	0,20	0.6	1,27	3.6
40,00	2,97	7.4	1,70	4.2	1,27	3.2
50,00	5,97	11.9	4,70	9.4	1,27	2.5
60,00	8,97	14.9	7,70	12.8	1,27	2.1
80,00	14,97	18.7	13,70	17.1	1,27	1.6
100,00	20,97	21.0	19,70	19.7	1,27	1.3
120,00	26,97	22.5	25,70	21.4	1,27	1.1
140,00	32,97	23.6	31,70	22.6	1,27	0.9
160,00	38,97	24.4	37,70	23.6	1,27	0.8
180,00	44,97	25.0	43,70	24.3	1,27	0.7
200,00	50,97	25.5	49,70	24.8	1,27	0.6
220,00	56,97	25.9	55,70	25.3	1,27	0.6
240,00	62,97	26.2	61,70	25.7	1,27	0.5
300,00	83,34	27.8	79,70	26.6	3,64	1.2
350,00	104,82	29.9	98,19	28.1	6,63	1.9
			MARRIED COUPLES *			
50,00	0,89	1.8	0,00	0.0	0,89	1.8
60,00	3,89	6.5	1,87	3.1	2,02	3.4
80,00	9,89	12.4	7,87	9.8	2,02	2.5
100,00	15,89	15.9	13,87	13.9	2,02	2.0
120,00	21,89	18.2	19,87	16.6	2,02	1.7
140,00	27,89	19.9	25,87	18.5	2,02	1.4
160,00	33,89	21.2	31,87	19.9	2,02	1.3
180,00	39,89	22.2	37,87	21.0	2,02	1.1
200,00	45,89	22.9	43,87	21.9	2,02	1.0
220,00	51,89	23.6	49,87	22.7	2,02	0.9
240,00	57,89	24.1	55,87	23.3	2,02	0.8
300,00	76,57	25.5	73,87	24.6	2,70	0.9
350,00	97,21	27.8	90,42	25.8	6,79	1.9

* Calculation assumes that only the husband has earned income.

REDUCTION OF PERSONAL INCOME TAX

In 1979 I reduced the basic rate of income tax from 33% to 30% and cut the top rates. That was one of the first and most radical of the many changes that found a place in my first four Budgets. This year we can cut personal taxation again. But I do not propose any further reductions in rates. For the reasons I have just given it is thresholds and allowances that must take priority.

Two years ago, in order to curb inflation and allow lower interest rates, income tax allowances were not raised at all. That was a difficult decision in the circumstances. And it has since brought great benefits. It was the firmness of that 1981 Budget which paved the way towards the lower inflation and lower interest rates which today offer the prospect of lasting economic recovery.

It is right that the benefit of the sacrifices of 1981 should be enjoyed now by those who made them then.

Last year I increased tax thresholds and bands by 14%. This year I also propose an increase of 14%. But because inflation is today so much lower that now represents a real increase of not 2%, as last year, but 8½%.

Income tax thresholds will be increased for the single person from £1,565 to £1,785 and for the married person from £2,445 to £2,795. The additional personal allowance paid to single parents and the widow's bereavement allowance will be increased in consequence from £880 to £1,010. The age allowance for a single person will go up from £2,070 to £2,360 and for a married person from £3,295 to £3,755. Corresponding increases will be made in the higher rate thresholds and bands and the threshold for the investment income surcharge.

Effect will be given to these changes under PAYE as from the first pay day after 10 May. For a married man on the basic rate they will be worth £2 a week. The cost to the PSBR, above indexation, will be £1bn next year. Including indexation, the total revenue foregone will amount to some £2bn in 1983-84 and £2½bn in a full year. Some 1½m fewer people will pay tax in 1983-84 than if thresholds had remained at their present levels.

At the start of my speech, I referred to the objectives this Government adoped in 1979, to which we have held, and still hold. From my first Budget we have pursued those objectives with consistency and firmness of purpose, and laid the foundations for sustainable recovery.

This is a Budget for the recovery: a Budget for the family, a Budget for enterprise - and, most of all, a Budget for Britain's continuing recovery.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. Addresses of publishers which do not appear in this list are indicated in the item concerned.

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As is the case with many developing countries the Indian tax system has grown in a haphazard way. As a result the system has become very complex so that frequently commissions had to be set up to review the tax structure. One of the serious shortcomings is the differential tax treatment of agricultural and non-agricultural income resulting in inequitable treatment of taxpayers. Marginal income tax rates are very high and although many tax concessions exist, it is the high-income group of taxpayers who most benefit from such concessions. Indirect taxes contribute nearly three fourths of national revenue but problems exist with respect to double or even multiple taxation of commodities.

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On 20-24 June 1983 the Centro Interamericano de Administradores Tributarios/Inter-American Center of Tax Administrators will hold its 17th General Assembly in the Netherlands Antilles.

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Lee Fook Hong:

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The Minister for Trade and Industry presented a rather gloomy 1983 Budget to Parliament. However, no major changes were made in the tax legislation. Some additional tax concessions for industrials were proposed, companies will receive improved treatment for royalties and 100% depreciation for computers and office automation equipment and a number of excise duties will be increased.

ASIAN-PACIFIC TAX & INVESTMENT RESEARCH CENTRE: TAX PLANNING/TAX AVOIDANCE & TAX EVASION 230

On 19 and 20 July 1983 the Asian-Pacific Tax & Investment Research Centre will sponsor a tax conference on the above subjects in Singapore.

M.A. Gª Caballero:

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New measures regarding, among other things, individual income and net wealth tax, capital gains taxation and the introduction of a unilateral measure to prevent double taxation.

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ERRATUM

The list of addresses of the major publishing houses which appeared on page 47 of the January issue of the *Bulletin* indicates an incorrect address of the International Customs Tariff Bureau. The correct address is: rue de l'Association 38, 1000, Brussels, Belgium.

INHALTSVERZEICHNIS

K. Kooijman:

Artikel 16 – Die Haltung der U.S.A. zum tax treaty shopping 195

Die Schweiz und die Niederlande stellen die hauptsächlichen Angriffsziele einer Kampagne der U.S.-Behörden gegen das tax treaty shopping dar. Der Verfasser untersucht die verschiedenen Versionen, die vorgeschlagen wurden, wie auch die Art und Weise, mittels derer das entsprechende Konzept Eingang in verschiedene Doppelbesteuerungsabkommen gefunden hat.

SOMMAIRE

K. Kooijman:

Article 16 – L'attitude américaine à l'égard du "Treaty shopping" 195

La Suisse et les Pays-Bas sont les premières cibles de la croisade conduite par les Etats-Unis contre le "tax treaty shopping"; l'auteur analyse donc les différentes versions qui ont été proposées et comment des dispositions ont pu être insérées dans un certain nombre de conventions fiscales.

Piroska E. Soos:

Ausländisch-beherrschte Gesellschaften – Ein Sieg für die Steuerzahler 201
Die Autorin bespricht die Entscheidung eines Bundesrevisionsgerichtes, das feststellte, das bestimmte Zahlungen von Mieten und Lizenzgebühren an eine holländische Gesellschaft keine "foreign personal holding company"-Einkünfte im Sinne der Subpart F-Gesetzgebung darstellen und folglich nicht der U.S.-Einkommensteuer in der Sphäre der (U.S.)-Anteilseigner der holländischen Gesellschaft unterworfen werden dürfen.

Kailash C. Khanna:

Der indische Haushalt 1983/84 207
Zusammenfassung der wichtigsten Bestimmungen des Haushaltes 1983/84 und Wiedergabe der Stellungnahmen der Wirtschaft.

Indien: Der Haushalt 1983/84 209
Auszüge aus der Haushaltsrede, die der Finanzminister, Herr Pranab Mukherjee, am 28. Februar 1983 hielt. Die Regierung strebt folgende Ziele an: die Stärkung der produktiven Kräfte, Eindämmung der Inflation, Anreize für das Sparen und Förderung wichtiger Investitionen.

Anil Kumar Jain und Inu Jain:

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Das Steuersystem Indiens entwickelte sich unsystematisch, was bekanntlich auch für eine Vielzahl anderer (Entwicklungs)länder zutrifft. Eine Folge dieser Entwicklung ist in der Komplexität des Systems zu sehen, und schon viele Kommissionen beschäftigten sich mit seiner Durchleuchtung. Einer der wichtigsten Nachteile besteht in der unterschiedlichen steuerlichen Behandlung der Einkünfte aus Landwirtschaft gegenüber denen aus anderen Tätigkeiten, was zu Ungerechtigkeiten führt. Zwar sind die Grenzsteuersätze hoch; durch das Gewähren einer Vielzahl von Steuervergünstigungen wird die progressive Steuer jedoch ausgehöhlt, und es sind folglich die oberen Einkommensschichten, die am meisten von den Steuervergünstigungen profitieren. Die indirekten Steuern machen fast 3/4 des Steueraufkommens aus; hier bestehen aber Probleme insofern, als verschiedene Güter einer zwei- oder mehrfachen Besteuerung unterworfen werden.

XVII. Generalversammlung der CIAT: Auswirkungen der Anwendung neuer Technologien auf die Steuerverwaltung 222
Die 7. Generalversammlung der CIAT findet in der Zeit vom 20.-24. Juni 1983 auf den Niederländischen Antillen statt.

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Lee Fook Hong:

Zusammenfassende Anmerkungen zu Singapurs Haushalt 1983 ... 225
Der Minister für Handel und Industrie legte dem Parlament einen recht düsteren Haushalt 1983 vor. In bezug auf die Steuergesetze sind keine wichtigen Änderungen vorgesehen. Es gibt lediglich einige Vorschläge, durch die z.B. zusätzliche Vergünstigungen für natürliche Personen vorgeschlagen werden; ferner sind für Gesellschaften verbesserte Bestimmungen für Lizenzgebühren und eine sofortige Abschreibung für Computer und Büroautomatisierungsgegenstände vorgesehen. Schliesslich soll eine Reihe von Verbrauchsteuern erhöht werden.

Asian-Pacific Tax and Investment Research Centre: Steuerplanung, Steuervermeidung, Steuerhinterziehung 230
Das Asian-Pacific Tax and Investment Research Centre fördert die am 19. und 20. Juli 1983 zum obengenanntem Thema stattfindende Konferenz.

M.A. Gª Caballero:

Kolumbien: Die Steueränderungen für 1983 232
Vorstellung der Massnahmen, die u.a. die Bestimmungen betreffend die Einkommensteuer für natürliche Personen, die Vermögensteuer und die Vermögensgewinnbesteuerung ändern sowie einseitige Vorschriften zur Vermeidung der Doppelbesteuerung einführen.

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Piroska E. Soos:

Filiales étrangères – Victoire pour les contribuables 201
L'auteur étudie une décision récente d'une cour d'appel fédérale ayant décidé que certains loyers et redevances provenant d'une société hollandaise ne constituent pas les revenus d'une "foreign personal holding company" tels qu'ils sont définis par la sous-section F de la loi sur les sociétés et les actionnaires américains de la société hollandaise ne seront pas assujettis, pour ces revenus, à l'impôt américain sur les revenus.

Kailash C. Khanna:

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Résumé des principales dispositions du Budget de l'Inde pour 1983-84 et discussion sur les réactions des cercles d'affaires.

Inde: Budget 1983-84 209
Extraits de la présentation du Budget prononcée le 28 février 1983 par Monsieur le Ministre des Finances, Pranab Mukherjee. Les desseins du Gouvernement sont: la consolidation des forces productives, le contrôle de l'inflation, l'encouragement à l'épargne et la promotion des investissements essentiels.

Amil Kumar Jain et Inu Jain:

Coup d'oeil rapide sur le système fiscal indien 215
Comme c'est le cas dans de nombreux pays en voie de développement le système fiscal indien a été élaboré d'une façon chaotique, ceci explique la complexité de ce système et la création de commissions devant réviser la structure fiscale. La différence de traitement fiscal entre les revenus agricoles et non-agricoles entraînant un traitement inéquitable des contribuables est l'un de ses sérieux défauts. Les taux des revenus marginaux sont très élevés et bien que de nombreuses réductions fiscales soient prévues, c'est le groupe des contribuables à hauts revenus qui bénéficient le plus de telles réductions. Les impôts indirects contribuent presqu'aux trois quarts du revenu national mais il y a des problèmes de double, voire de multiple, imposition des produits.

XVIIe Assemblée Générale CIAT: impact de la nouvelle technologie sur l'administration fiscale 222
Du 20 au 24 juin 1983 le Centro Interamericano de Administradores Tributarios/Inter-American Center of Tax Administrators tiendra aux Antilles néerlandaises sa 17ème Assemblée Générale.

Carnet des Congrès 224

Lee Fook Hong:

Budget 1983 de Singapour – Résumé 225
Le Ministre du Commerce et de l'Industrie a présenté au Parlement un Budget 1983 plutôt sombre. Toutefois aucune modification importante n'a été introduite dans la législation fiscale. Quelques concessions fiscales supplémentaires ont été proposées pour les personnes physiques, les sociétés bénéficieront d'un traitement plus favorable pour les redevances et 100% d'amortissement pour les ordinateurs et l'équipement automatisé de bureau; un certain nombre de droits d'accise ont été augmentés.

Centre de recherche sur la fiscalité et les investissements dans l'Asie et le Pacifique: gestion fiscale/fraude et évasion fiscales 230
Les 19 et 20 juillet 1983 le Centre de recherche organisera une conférence fiscale sur les sujets mentionnés ci-dessus.

M.A. Gª Caballero:

Colombie: Amendements fiscaux pour 1983 232
Nouvelles dispositions portant entre autres sur l'impôt sur le revenu des personnes physiques et l'impôt sur la fortune, l'imposition des plus-values et l'introduction d'une disposition unilatérale afin d'éviter la double imposition.

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Article 16: The U.S. Attitude to Treaty Shopping

by K. Kooiman

Mr. Kooiman is Head of the Taxation and Corporate Structure (The Hague) of Shell Internationale Petroleum Maatschappij B.V.

This article contains mainly the text of a paper presented at the Swiss/Dutch IFA Seminar in Lucerne (Switzerland), 28-29 April 1983.

"The fact that the draft article 16 would redefine who is entitled to benefits under tax treaties is as fundamental as any proposal ever made in the treaty area and would be the most significant substantive change in the development of international tax treaties since before the original OECD Model Convention in 1963."

"The adoption of rules in the case of all corporate entities to look through the ownership of such companies and require qualification as to residence of the shareholders (and related persons) is such a fundamental substantive change, together with the procedural changes that might be required, that it could have a marked impact on the role of both corporations and tax treaties in international trade and investment."

These quotes from a letter sent to Alan Granwell, International Tax Counsel to the U.S. Treasury, in January 1982 by Robert Patrick, Chairman of the Task Force on International Tax Policy of the U.S. Chamber of Commerce,[1] are a good indication of the stir caused in the international tax community by the change in the attitude of the United States Treasury to treaty shopping. The stir has by no means abated, the Treasury, rather than showing signs of repentance, has only given indications of firm resolve, and the recent Blum report,[2] according to which an estimated $ 25 billion from tax evasion and organized crime in the U.S. is exported annually to tax havens for laundering is hardly likely to soften the hearts of those that have declared war on treaty shopping and who show a tendency of not distinguishing between avoidance and evasion.

Since both Switzerland and the Netherlands belong to the select group of prime targets of this American crusade it is fitting that today we discuss article 16. As an introduction I propose to address some aspects that I find of particular interest. Considering the abundance of published material on this subject, amongst which some excellent general articles,[3] it would appear that I may dispense with a systematic introduction.

SEEKING A PROPER PERSPECTIVE

David Rosenbloom reports in an article[4] that "Congress . . . seems to perceive a moral issue – fragrant with considerations of tax equity". That may not be a surprising attitude, anyway, for politicians, but neither is it surprising considering the unfavourable connotation of "tax havens" and "treaty shopping". It is important that both treaty shopping and the United States reasons for acting against it are judged objectively and in the light of historical developments. Only then is a reasonable international discussion possible on pros and cons of the U.S. approach.

Treaty shopping, which I trust requires no definition here, has been around for a long time. With regard to U.S.-source income David Tillinghast[5] identifies as principal tax reasons for treaty shopping the following:

- avoiding double taxation,
- seeking protection under the "permanent establishment" rule,
- obtaining the "annual net election" for real estate income,
- reducing or eliminating U.S. withholding taxes, and that includes the "secondary" withholding tax.

For a long time the U.S. Treasury had accepted, or at least not very actively resisted, these various consequences of treaty shopping. It is my impression that statements by Treasury officials made as recently as

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1. Dated 14 January 1982; text available i.a. from *Taxes International* doc 25-527 (6 pages).
2. According to the Financial Times of 26 March 1983 a report on offshore banks and trust companies was prepared by Professor Richard Blum for the Permanent Sub-Committee on Investigations of the Senate Committee on Government Affairs.
3. Some general articles:
   - "Treaty shopping: observations on the U.S. approach" by Robert J. Patrick, Jr. speaking at the joint U.S./Dutch IFA meeting in New York City on 10 September 1982. Extensive notes were available to participants, excerpts in *Bulletin for International Fiscal Documentation* No. 3 1983 pp. 105/6 (International Bureau of Fiscal Documentation (IBFD));
   - "Further attacks on treaty shopping" by the staff of the IBFD, *European Taxation* 1981/5-6 vol. 21 pp. 141/156, a publication of IBFD;
   - "The causes and implications of treaty shopping" by David B. Tillinghast, excerpt of a statement of 29 April 1980 before the "Subcommittee on Oversight" of the Ways and Means Committee of the U.S. Congress' House of Representatives, published in 9 *Taxes International,* May 1980 pp. 6-13;
   - "The U.S. Treasury sharpens its attack on treaty shopping" by Marshall J. Langer in 27 *Taxes International,* January 1982 pp. 40/1, describing the hardening of the U.S. Treasury attitude over 1981 in 21 brief points. Langer used these points on a speaking outline when addressing the British branch of IFA on 19 January 1982 in London;
   - "The shoppable treaty: should it become extinct?" by Philip T. Kaplan in *Tax Management International Journal,* June 1982 pp. 3-12;
   - "Current developments in regard to tax treaties", H. David Rosenbloom, chapter 31 of the "40th annual N.Y.U. institute" especially pp. 31-65 to 31-76 and 31-99 to 31-106;
   - and of course the IFA booklet "Recourse to tax havens – Use and abuse" of the seminar of the 34th Congress 1980 in Paris, which contains an extensive selection of literature.
4. "U.S.–Netherlands Antilles Negotiations" by H. David Rosenbloom, *Tax Planning International Review,* vol. 9, July 1982, pp. 14-16.
5. See note 2., pp. 6/7.

1979[6] confirm a resignation to the existence of treaty shopping and a recognition of the substantial economic and financial importance to the U.S. of tax haven conventions. A case in point are the "finance subsidiaries" of which it is thought that the United States might accept continued existence even under a renegotiated treaty with the Netherlands Antilles. This history suggests that the United States has taken a very pragmatic approach to treaty shopping, deciding that "leaving things be" was in the best interests of the U.S.

Against this background the recent change of attitude of the U.S. can only be seen as the result of, again, a pragmatic reappraisal. The economic and financial importance I just mentioned apparently no longer compensates for the drawbacks the U.S. perceives. This U.S. perception is best summarized by the remarks of Leslie Schreyer, Deputy International Tax Counsel in the first U.S. Treasury public hearing on treaty shopping in January 1982: without anti-avoidance provisions the United States has a one-way treaty with the world and the absence of strong anti-avoidance provisions does not provide incentives for U.S. trading partners to enter into treaties.[7]

If one accepts this interpretation of history, some observations may be made:

1. Treaty shopping need not be whipped into a "moral issue". Forms of treaty shopping may range from "good" to "bad" as various authors maintain, but they have not all suddenly become the moral equivalent of evasion.
2. If only some years ago the United States considered that action against treaty shopping was not economically indicated, perhaps the net disadvantage now perceived has not yet grown to such proportions that urgent remedies are essential. The U.S. should still find time for a basic discussion, preferably in the forum of the OECD, on two essential questions: what constitutes abuse or inappropriate use of tax treaties? And can international consensus on the principles of anti-avoidance be achieved?
3. If article 16 is incorporated in a treaty, there is a very good case for a grandfather clause. A pragmatic shift in attitude cannot be a justification for putting an additional tax burden on an investor who had justifiably assumed certain tax consequences from arranging his affairs in the light of the then known attitude of the United States.

When trying to set the proper perspective one must of course take into account the problem of evasion. I think you will agree with me that the effective fighting of evasion and fraude can but benefit bona fide tax practitioners: the identification of treaty shopping with tax evasion affects public perception of the former. However, evasion should not be combatted with wide-spectrum measures: not only can they indiscriminately punish "good" treaty shopping, their effect may well reach further. It is my impression that the current U.S. blanket approach of avoidance *and* evasion contains an element of overkill that must at least in part be blamed on the ardent desire to combat evasion. The application of more specific measures against evasion – improved access to information is generally considered to be a very important one[8] – would allow for treaty-shopping to be approached in a more balanced and dispassionate fashion.

THE SIGNIFICANCE OF ARTICLE 16

As yet there is not *an* article 16. In December 1981[9] the U.S. Treasury indicated that examples of specific provisions which might be used in article 16 could be found in:

- article 16 of the June 16, 1981 draft Model;
- article 17 of the U.S./Jamaica treaty[10];
- the anti-abuse reservation to the U.S./Argentina treaty which is signed, but not yet in force;
- the discussion draft of December 23, 1981.

To the list we must now add as other possible versions the articles 16 of the new U.S.–Australia treaty[11] and the new U.S.–New Zealand treaty,[12] which were both signed in 1982. In Chart A I have put these six versions together and, as a souvenir of la belle époque, I added article 16 of the 1977 model.

I will now try to identify briefly, in a very schematic fashion, and certainly not exhaustively, the main characteristics of the various versions:

The 1977 version is short and sweet: if 25% or more of a company's shareholders are not residents of the residence country *and*, by reason of special measures, tax in the residence country on dividend, interest or royalties from the source country is substantially less than tax on corporate business profits, then the source country may deny relief.

The June 1981 draft:

1. any entity (rather than just a company) in the residence country is not entitled to any treaty relief in the source country unless
   a) more than 75% of the beneficial interest in it can be traced to individuals of the residence country (substantial trading of stock on recognized stock exchange presumes ownership) *and*
   b) its tax base is not substantially reduced by liabilities to third country residents (i.e. conduit rôle)
2. relief is available on proof that obtaining treaty benefits was not *a* principal purpose of acquisition or maintenance of the company and of its operation

6. Testimony of H. David Rosenbloom on 24 April 1979 to the Oversight Subcommittee of the Ways and Means Committee of the U.S. Congress' House of Representatives, as excerpted in 9 *Taxes International* May 1980, pp. 34-38.
7. "Treaty shopping: the first U.S. Treasury public hearing" by Bruce Zagaris, 28 *Taxes International*, February 1982 pp. 3/4.
8. E.g.: Patrick's letter referred to in 1. and Patrick's speech referred to in 2.;
   - also pp. 52 and 54 of "EG-concept-richtlijn tegen tax-havenvennootschappen op komst?", M.A. Wisselink, *Economisch Statistische Berichten* 10.1.1979, pp. 49-54;
   - also the Dutch Underminister for Finance in a question and answer session with the Finance Committee of the Second Chamber of Parliament ("Kamerstuk 15.975,,, reported in "Vakstudienieuws 9 February 1980").
9. "Treasury announces public meeting on model income tax treaty", press release of the U.S. Department of the Treasury, 23 December 1981.
10. Entered into force 29 December 1981.
11. Signed 6 August 1982, not yet in force.
12. Signed 23 July 1982, not yet in force.

CHART A

U.S.DRAFT TREATY 1977

Article 16
Investment or holding companies

If 25% or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Article 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties. For the purposes of this Article, the source of dividends, interest or royalties shall be determined in accordance with paragraph 3 a), b), or c) of Article 23 (Relief from Double Taxation).

JUNE DRAFT

Article 16
Limitation on benefits

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
a) more than 75% of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph a) a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.

DECEMBER DRAFT
(Discussion Draft)

Article 16
Investment of holding companies

1. A corporation which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State with respect to an item of income, gains or profits unless the corporation establishes that:
a) its stock of any class is listed on an approved stock exchange in a Contracting State, or that it is wholly owned, directly or through one or more corporations each of which is a resident of a Contracting State, by a corporation the stock of which of any class is so listed; or
b) it is not controlled by a person or persons who are not residents of a Contracting State, other than citizens of the United States; or
c) it was not a principal purpose of the corporation or of the conduct of its business or of the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived to obtain any of such benefits.

2. For the purposes of this Article:
a) an approved stock exchange in.... means....:
b) an approved stock exchange in the United States means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;
c) a person or persons shall be treated as having control of a corporation if under the income tax laws of the Contracting State in which the income arises the person or persons could be treated as having direct or indirect control of the corporation for any purpose;
d) notwithstanding subparagraph c) of this paragraph, a corporation is presumed to meet the requirements of subparagraph b) of paragraph 1 of this Article if the corporation establishes that individuals who are:
i) citizens of the United States; or
ii) residents of a Contracting State; or
iii) residents of States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention;
own directly more than 75% of total combined voting power of all classes of the corporation's stock entitled to vote and more than 75% of the number of shares of each other class of the corporation's stock;
e) a corporation is presumed to meet the requirements of subparagraph c) of paragraph 1 of this Article, in particular where:
i) the reduction in tax claimed is not greater than the tax actually imposed by the Contracting State of which the corporation is resident;
ii) the corporation is engaged in business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is incidental to or derived in connection with such business.

U.S.–JAMAICA TREATY

Article 17
Limitations on benefits

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
(a) more than 75% of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
(b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State, other than any such persons who are individuals subject to tax in a Contracting State on their world-wide income by reason of citizenship.

A company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed, solely for purposes of subparagraph (a), to be owned by individual residents of the Contracting State in which the company is resident, as determined under Article 4 (Residence).

2. Paragraph 1 shall not apply if it is determined that the acquisition, ownership or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under this Convention.

3. The requirements of paragraph 2 are satisfied, in particular, where a company resident in Jamaica and owned by individual residents of third States derives income with respect to which the company claims United States tax benefits under this Convention, the company does not use such income in the manner described in paragraph 1(b) and:
(a) the company is engaged in business operations in Jamaica and the income with respect to which the company claims United States tax benefits is incidental to or derived in connection with the business operations in Jamaica; or
(b) the individuals owning the company are residents of countries that have income tax conventions in force with the United States and, pursuant to such conventions, the individuals would have been entitled to United States tax benefits the same as, or substantially similar to, the United States tax benefits claimed by the company under this Convention, had the individuals earned the income directly.

The provisions of this paragraph shall apply, mutatis mutandis, to a company resident in the United States and owned by residents of third States that derives income with respect to which Jamaican tax benefits are claimed under this Convention.

U.S.–NEW ZEALAND TREATY

Article 16
Limitation on benefits

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
(a) more than 75% of the beneficial interest in such person (or in the case of a company, more than 75% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:
(i) individuals who are residents of the United States;
(ii) citizens of the United States;
(iii) individuals who are residents of New Zealand;
(iv) companies as described in subparagraph (b); and
(v) the Contracting States; or
(b) it is a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange; or
(c) the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the Convention.

2. For the purposes of paragraph 1(b), the term "a recognized stock exchange" means:
(a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; and
(b) the New Zealand Stock Exchange; and
(c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

3. Where
(a) income derived by a trustee is to be treated for the purposes of the Convention as income of a resident of a Contracting State; and
(b) the trustee derived the income in connection with a scheme a principal purpose of which was to obtain a benefit under the Convention;
then, notwithstanding any other provision of the Convention, the Convention does not apply in relation to that income.

4. Before a resident of a Contracting State is denied relief from taxation in the other Contracting State by reason of this Article the competent authorities of the Contracting States shall consult each other.

U.S.–AUSTRALIA TREATY

Article 16
Limitation on benefits

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless:
(a) more than 75% of the beneficial interest in such person (or in the case of a company, more than 75% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:
(i) individuals who are residents of the United States;
(ii) citizens of the United States;
(iii) individuals who are residents of Australia;
(iv) companies as described in subparagraph (b); and
(v) the Contracting States; or
(b) it is a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange in one of the Contracting States; or
(c) the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the Convention.

2. For the purposes of sub-paragraph (1)(b), the term "a recognized stock exchange" includes, in relation to the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc.

3. Where:
(a) income derived by a trustee is to be treated for the purposes of this Convention as income of a resident of a Contracting State; and
(b) the trustee derived the income in connection with a scheme a principal purpose of which was to obtain a benefit under the Convention;
then, notwithstanding any other provision of this Convention, the Convention does not apply in relation to that income.

PROPOSED SENATE RESERVATION TO PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND ARGENTINA

Reservation that, a person (other than an individual) which is a resident of a Contracting State and which derives income from sources within the other Contracting State shall not be entitled to the benefits under this Convention accorded by that other Contracting State if: 25% or more of the beneficial interest in such person is owned, directly or indirectly, by individuals who are not residents of the first-mentioned Contracting State. For purposes of this paragraph, a corporation that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by residents of that Contracting State. This paragraph shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the Convention.

3. source country relief is denied if the relevant income is taxed significantly less in the residence country than similar income arising there.

Compared with the 1977 version: the burden of proof shifted; the shareholding test now stands alone; the presumption of ownership is new; the conduit test is new; "special measures" is exempted to "the law in force"; new also is the exoneration by a demanding proof of "bona fides" (i.e. lack of evil purposes).

The discussion draft (December 1981) is longer still:

1. A residence country corporation is not entitled to source country treaty relief unless it establishes that
   a) its stock is listed on an approved stock exchange or that its final 100% owner is so listed *or*
   b) it is not controlled by third country residents (unless they are U.S. citizens)*or*
   c) obtaining treaty benefits was not *a* principal purpose of the company or the conduct of its business or the acquisition or maintenance by it of the income producing property (including shares)
2. a) . . .
   b) . . . .
   c) Control means direct or indirect control for any purpose under the income tax laws of the source country
   d) "No control by third country residents" is presumed if the corporation establishes that it is owned more than 75% by U.S. citizens, or residents of either treaty country, or residents of a country that has a treaty with the source country which provides at least equal relief
   e) The "bona fides" of a corporation is presumed if the treaty relief claimed is not greater than the tax imposed in the residence country or if the treaty relief relates to income which is incidental to business operations in the residence country.

Relative to the June draft: the shift in the burden of proof is emphasized; there are more safe harbors and presumptions; the control test changed from "more than 75% owned by residence country residents" to "no control by third country residents (excluding U.S. citizens)"; new is that control is construed under source country law and "more than 75% qualified ownership" has returned as an exonerating presumption; the ownership presumption from substantial trading on a recognized stock exchange of the residence country changed to safe-harbor for listing on an approved stock exchange of either contracting state; there are changes in the bona fides test; the conduit test has gone; the denial of benefits if similar income in the residence country is taxed less is replaced by a presumption of bona fides if treaty relief is at least matched by tax cost in the residence country or if the relevant income is linked with operations in the residence country.

I shall be very brief about the remaining four versions.

The Argentina reservation denies treaty benefits to the entity if 25% or more of the beneficial interest therein is owned by residents of any country but the residence country. The ownership presumption in case of trading on an exchange is identical to the June draft, and so is the bona fides exoneration.

The Jamaica article 17 effectively follows the first two sections of the June draft and further provides a safe-harbor for the bona fides test in case a company is owned by third country individuals and is not a conduit when the relevant income is linked to residence country operations or when the owners could have claimed similar treaty benefits had they received the income indirectly.

The Australian version's first two sections effectively follow the June draft but do not contain a conduit test and the ownership test is relaxed in that residents of either country, citizens of the U.S. and companies whose stock is traded on either country's exchanges qualify; the third section denies relief in certain cases of income derived by a trustee where the burden of proof appears to rest with the tax authorities.

The New Zealand version is effectively similar to the Australian one but contains the interesting addition that treaty relief can only be denied under this article after the competent auhorities have consulted.

The least one can say is that the variety is interesting: I am less certain about its whetting the appetite. In Chart B I have attempted to chart the principal tests, presumptions and safe-harbors in order to illustrate their interrelationship and to facilitate comparison of the versions of "article 16" available so far.

The picture I tried to paint is not complete without the observation that the proposed new model treaty (i.e. the 1981 version) no longer contains the protection against "secondary" withholding tax.

QUESTIONS RAISED BY ARTICLE 16

I should like to mention a few observations on the interpretation and application of article 16. I should add that it appears difficult to be original; many people have already covered this ground.

"Bona fides" must be established by the taxpayer by proving that the obtaining of benefits was not a principal purpose. This must cause problems considering "difficulty of proving a state of mind"[13]. It will on the one hand create intensive demand for advance rulings[14] and on the other in the case of litigation place a great burden on the taxpayer in the face of a necessarily uncertain outcome.

The resorting to the source country's income tax laws for definition of a treaty term is not a novum, but definitely unfortunate. In this case it requires of a taxpayer that he recognizes and appreciates all control definitions for whatever purpose in the source country's tax laws. Furthermore the meaning of treaty terms can now vary with changes in the legislation of a treaty partner.[15]

The presumptions that crop up in the different versions of article 16 appear to be looked at in different ways.

13. Kaplan on p. 8 of the article cited in note 2. Also, Leslie J. Schreyer stated in the first public hearing "that Treasury had not determined a method for identifying such a purpose", see note 7.
14. E.g. "New Model Income Tax Treaty", Burge and Packer, *Intertax* 1982/2 pp. 53-61 especially p. 60; in the same vein Bruce Zagaris in the conclusion of the report "Treasury shopping: the second U.S. Treasury public hearing" in 29 *Taxes International*, March 1982 pp. 5/6.
15. Cf. statement by William Burke in second U.S. Treasury public hearing (See note 14).

CHART B

This chart attempts to illustrate very roughly the operation and interrelation of the various tests appearing in the different versions of article 16. To achieve comparability between the versions the tests of this chart have all been phrased as tests to be met, thus the relevant article 16 text may be in the positive and the wording in the chart in the negative or vice versa.

Bear in mind that:

- the chart only summarily covers the situation, it does not define precisely, nor does it reflect all details (e.g. those relating to stock exchanges);
- the Australia/New Zealand §3 covering income derived by a trustee is omitted;
- the chart does not address the question of burden of proof;
- §4 of the New Zealand version is not reflected.

Note: – "SC" indicates the country where the relevant income arises
– "RC" is the country of residence of the person claiming treaty relief.

	I 1977 model	II 1981 june draft	III 1981 discussion draft	IV Argentina reservation	V Jamaica art. 17	VI Austr. & Nw. Zealand art. 16
Which income is affected:	dividend, interest, royalties	any income	as in (II)	as in (II)	as in (II)	as in (II)
if received by whom:	a company	for 1, 2, 4: any entity for 3: any person	a corporation	any entity	any entity	any entity
WHICH TEST(S) MUST BE MET IF RELIEF IS NOT TO BE DENIED:	EITHER (1) OR (3)	(3) AND EITHER BOTH (1) AND (2) OR (4)	(1a) OR (1b) OR (4)	(1) OR (4)	EITHER BOTH (1) AND (2) OR (4)	(1a) OR (1b) OR (4)
TESTS 1 Ownership/control of the entity receiving the income	≥ 25% of the capital is not owned (in)directly by individuals not resident in RC	> 75% of beneficial interest in entity is owned (in)directly by individuals resident of RC	a) its stock is listed on exchange in either state, or a company so listed (in)directly wholly owns it b) not controlled by persons who are neither residents of either state nor U.S. citizens	≥ 25% of the beneficial interest in the entity is not owned (in)directly by individuals not resident in RC	as in (II)	a) its stock is traded on exchange of either state b) 75% of beneficial interest in entity owned (in)directly by: - individuals resident in either state and/or - U.S. citizens and/or - companies falling under (1a) and or - either Contracting State
Presumptions	——	company is owned by individuals resident in treaty country in which stock is traded on exchange	(1b) is presumed met if 75% stock is owned by individuals: - resident in either state or - U.S. citizen or - resident in 3rd country having treaty with SC giving at least equal relief	as in (II)	company is owned by individuals in its country of residence if its stock is traded on exchange in either country	——
2 Conduit rôle of entity receiving the income	——	tax basis is not substantially reduced by (in)direct liabilities to 3rd country residents who are not U.S. citizens	——	——	as in (II)	——
3 Tax regime in RC	tax on relevant income is not, by reason of special measures, lower than that on corporate business profits	tax on relevant income is not, under the law in force, significantly lower than that on similar income arising in RC	(not a "test" here, see (4) below) relief claimed is not greater than tax actually imposed on relevant income	——	——	——
4 Obtaining treaty relief was not a principal purpose of: ...	——	acquisition or maintenance of entity and conduct of its operations	the corporation, or the conduct of its business or the acquisition or maintenance of the property producing the relevant income	as in (II)	as in (II) but here: acquisition, ownership or maintenance.	as in (II) but here: establishment, acquisition and maintenance
Presumptions/safe harbors	——	——	(4) is presumed met if: i - (3) is met or ii - relevant income is incidental to business operations in RC	——	(4) is met if: company resident in RC is owned by individuals resident in 3rd countries and (2) is met and either relevant income is linked with RC business operations or owners could claim similar treaty relief directly	——

Some authors make a plea for their being made into safe-harbors and consider them subject to rebuttal.[16] I gather that others understand the presumptions to be safe-harbors. Negotiators will be well advised to leave no doubt about this matter.

The words "tax actually imposed" in section 2. e) i) of the discussion draft must create much uncertainty. Not only may it take a very long time before the amount of tax is actually determined by assessment; questions about the effect of loss compensation (horizontally, vertically), the effect of directly or indirectly attributable expenses, and undoubtedly others will arise.[17]

Touche Ross[18] have proposed an interesting argument about the "bona fides" test in section 1. c) of the December draft. They question its justification in the light of United States case law under which only when no business reason exists other than a tax reason will there be grounds for denying a tax benefit. The United States treaty policy should not be more restrictive than domestic case law. I encountered an argument in the same vein in an article by Cooper and Rasmussen.[19] In respect of the ownership test they state that since the U.S. taxes on the basis of world-wide income without regard to the identity of the shareholders, access to the U.S. treaty system should be allowed on an equal basis, regardless of ownership. I am unable to judge the validity of both these arguments, but I certainly find them appealing.

CLOSING REMARKS

From what I have said so far you will have gathered that I agree with the statements of Robert Patrick which I quoted as an opening. For a long time international tax law has functioned on the premise that residence as determined under sovereign national tax law together with substance as determined in accordance with gradually evolving principles constituted an acceptable basis for treating a company as bona fide resident for treaty purposes. An approach as now proposed by the U.S. Treasury not only pierces the corporate veil to inquire into the quality of the shareholders (or in turn their shareholders, etc.) but may also discriminate between companies according to the nature of their business activities, even where third parties are involved. It presents an intrinsic departure from an internationally accepted pattern, and is bound to create a burden on taxpayers and tax authorities that is not commensurate with the anti-avoidance objectives that underly it. The very significant differences between the various versions so far available indicate that the stage has not yet been reached where a version could be designated the consensus model. There is justification for reconsideration by the United States of the course it should steer in these uncharted waters, not in the least because of both their traditional concern with the freedom of international trade and investment *and* the responsibilities that go hand in hand with the prominent position of the United States in the field of international taxation.

I agree wholeheartedly with the conclusions in a statement BIAC presented to the OECD earlier this year[20] and call your attention particularly to two of them:

– "BIAC strongly urges that the OECD member governments should refrain from introducing concepts in their tax treaties that will be harmful and impractical to apply, will significantly reduce the utility of the treaties, and will create tax burdens as barriers to cross border investments."
– "BIAC requests that the Committee on Fiscal Affairs undertake a review designed to arrive at a consensus on appropriate rule(s) governing the use of tax treaties by the third country residents".

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16. E.g. "U.S. approaches to treaty abuse – Article 16 of the United States model income tax convention: a commentary", Leo S. Ullmann, *Maandblad Belasting Beschouwingen* no. 5/6 May/June 1982, pp. 212-216 (esp. p. 216). The same assumption appears to underly a statement in the second treasury hearing that "the presumption set forth in 2(e) should be a safe harbor rule instead of a presumption" as reported in *Taxes International* (see note 15.). Similarly p. 292 of "Tax treaty shopping", Cooper and Rasmussen, *Bulletin for International Fiscal Documentation* (IBFD) 1982 No. 7 Vol. 36 pp. 291-297.
17. E.g p. 296 of the Cooper and Rasmussen article mentioned in note 16.
18. Touche Ross & Co. in a memorandum dated 6 January 1982 prepared in connection with the first Treasury hearing.
19. Pp. 292/3 of the article mentioned in note 16.
20. BIAC statement "Use of tax treaties by third country residents" dated November 1982.

United States: Controlled Foreign Corporations — A Victory for Taxpayers —

By Piroska E. Soos

I. REASONS FOR LEGISLATION

Although American individuals and companies wishing to engage in business abroad have numerous options regarding the form of the business operation,[1] the most widely used vehicle for doing so is a foreign corporation.[2] In the usual situation, the foreign corporation is controlled by one or more U.S. corporations and is a first or second tier subsidiary owned entirely or almost entirely, either by the U.S. parent corporation or the first tier subsidiary.[3] There are many business and tax reasons for using a foreign corporation, as for example, to protect the assets of the U.S. corporation or to try to avoid its subjection to the jurisdiction of foreign courts or administrative agencies.[4] In addition, foreign laws may require that the corporate form be used.

The tax advantages for using a foreign corporation stem primarily from the basic jurisdictional distinctions between domestic and foreign corporations recognized by the U.S. Internal Revenue Code (hereinafter "IRC").[5] Generally, foreign corporations are subject to U.S. tax only on income that is effectively connected with the conduct of a trade or business in the U.S.A. or on income from U.S. sources.[6] Therefore, if a foreign corporation has only foreign income, it can completely and legally avoid U.S. tax, even if it is owned by U.S. shareholders or is managed in the U.S.A.[7] Thus, taxation by the U.S.A. of the profits of a foreign corporation is deferred until the profits are repatriated to the U.S.A. in the form of dividends or liquidating distributions to the U.S. shareholders or until the shareholders sell their shares. Deferral may be an important tax advantage for U.S. taxpayers, and it may be permanent if the profits are reinvested.

By way of comparison, using a branch as a vehicle for doing business abroad does not have the benefit of tax deferral. The branch is not considered as a separate legal entity, and the U.S. owner is taxed in the U.S.A. on his worldwide income, including the branch profits, although he is entitled to a credit for foreign taxes paid.[8]

The tax avoidance possibilities provided by the tax deferral privilege are many and obvious, and it was believed that U.S. multinationals both used and abused the privilege. Often, they arranged their affairs or created structures, however artificial, for the primary purpose of maximizing the tax deferral benefit. This view was shared by former U.S. President John F. Kennedy who stated in 1961 that:

> "The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures – aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven – so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad."[9]

Contents

I. REASONS FOR LEGISLATION
II. ITEMS SUBJECT TO TAX UNDER SUBPART F
  A. General rules
  B. Foreign personal holding company income
  C. Related persons
III. A VICTORY FOR TAXPAYERS

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1. Other forms include, but are not limited to, a foreign branch, a DISC (domestic international sales corporation) and a domestic or foreign partnership. For a discussion of the various forms of doing business abroad, see Bischel, J.E. and Feinschreiber, R., *Fundamentals of International Taxation*, Practicing Law Institute, New York City, 1977 (hereinafter "*Fundamentals*") at 27-35 and Gifford, W.C. and Owens, E.A., *International Aspects of U.S. Income Taxation – Part III: Taxation of U.S. Citizens and Residents and Domestic Corporations on Foreign Source Income*, International Tax Program, Harvard Law School, Cambridge, Massachusetts, 1982 (hereinafter "Harvard") at 325-524.
2. *Fundamentals* at 29; Harvard at 361.
3. Harvard at 361.
4. Harvard at 326.
5. U.S. Internal Revenue Code of 1954, as amended.
6. IRC, Secs. 881, 882.
7. It should be noted that a foreign corporation is subject to tax in the country of incorporation, and if the rates of tax in that country are about the same as those in the U.S.A., no substantial benefit exists.
8. One advantage to using a branch is that the U.S. owner may set off losses incurred by the branch against its U.S.-source income. Shareholders of foreign corporations may not do so because such corporations are considered separate legal entities, and if the shareholders are corporations, the foreign corporations are generally excluded from a consolidated U.S. tax return. See IRC, Sec. 1504.
9. U.S. House of Representatives, House Report No. 1447, 87th Congress, 2d Session (hereinafter "House Report") at 57.

President Kennedy proposed that tax deferral be eliminated entirely,[10] and the proposal triggered a great deal of controversy. Those in agreement argued, among other things, that the tax law favored foreign over domestic investment, to the detriment of the U.S. economy, because the law encouraged the outflow of capital from the U.S.A. and provided a disincentive for U.S. shareholders to repatriate the earnings of foreign corporations.[11] Opponents of the proposal, who sometimes referred to it as the "imposition of an anticipatory tax",[12] contended that deferral was essential to enable U.S. multinationals to compete abroad with foreign companies organized in countries that, unlike the U.S.A., used the exemption method as the basic way of avoiding double taxation.[13]

The outcome of the debate was compromise legislation in 1962 which did not generally eliminate tax deferral but disallowed it in cases where aggravated abuses of the privilege were thought to exist. The legislation,[14] IRC, Secs. 951-964, commonly referred to as "Subpart F", is designed to eliminate tax avoidance by U.S. shareholders who use foreign corporations to accumulate certain types of income in a jurisdiction with little or no tax.[15] The rules in Subpart F attempt to distinguish between "legitimate" deferral and abusive tax avoidance consisting of the planned reduction of overall taxes, foreign and domestic, through the use of foreign subsidiaries in tax haven countries.[16]

Deferral was ended by subjecting to current U.S. tax certain U.S. shareholders of "controlled foreign corporations" (see Section II). Subpart F imposes a tax on U.S. shareholders, rather than foreign corporations,[17] who are required to include in taxable income for U.S. tax purposes certain profits, whether or not distributed, of their foreign corporations in the year derived.

Although Subpart F has wide impact and is very significant for foreign business operations, deferral of tax with regard to foreign profits still occurs frequently for several reasons. First, Subpart F does not eliminate deferral in all cases, so that U.S. shareholders who plan their business activities carefully, as did the shareholders in the case discussed in Section III, are not subject to current taxation on the profits of the foreign corporation. Secondly, Subpart F has not been entirely effective: the use of foreign corporations for tax avoidance is still very common and the number of U.S.-owned foreign corporations in tax haven countries increases every year.[18] This may be one of the reasons why some think it likely that there will be continuing pressure in the U.S.A. to eliminate tax deferral completely.[19]

The following sections of this article focus on a recent decision of a federal appellate court in the U.S.A. which considered whether or not certain rents and royalties (which are generally taxable under Subpart F as "foreign personal holding company income") derived by a controlled foreign corporation organized in the Netherlands were subject to U.S. tax. The court found that the rents and royalties did not constitute "foreign personal holding company income" as defined in Subpart F and, therefore, were not taxable under Subpart F in the hands of the Dutch corporation's U.S. shareholders. Before analyzing that decision in Section III, the provisions of Subpart F which are relevant to that decision are discussed in Section II.

II. ITEMS SUBJECT TO TAX UNDER SUBPART F

A. General rules

Subpart F applies to "U.S. shareholders" of a "controlled foreign corporation" (hereinafter "CFC") and subjects them to tax with regard to certain profits of the CFC if the foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year.[20] A foreign corporation is a CFC if stock representing more than 50% of the total voting power is owned directly, indirectly, or constructively by "U.S. shareholders."[21]

A "U.S. shareholder" is a "U.S. person" (i.e. a U.S. citizen or resident or a domestic corporation, partnership, trust or estate)[22] that owns directly, indirectly, or constructively stock representing 10% or more of the total voting power of a foreign corporation.[23] Voting power (rather than the value of stock) was used, and the 10% de minimus rule was included, in order to exclude "small" shareholders, who presumably have little influence over corporate policy, from the operation of Subpart F.[24]

Indirect ownership refers to ownership through a foreign

10. House Report at 57.
11. "Elimination of Tax Deferral for U.S. Multinational Corporations" in Surrey, S., McDaniel, P. and Pechman, J. (eds.), *Federal Tax Reform for 1976: A Compendium 77,* Fund for Public Policy Research, Washington, D.C., 1976, as reprinted in Harvard at 147, 148.
12. Lynn and Wiacek, *Keep "Deferral": U.S. Shareholders Should Not Be Taxed On Foreign Corporation Income Before They Receive It* (1978), as reprinted in Harvard at 133, 134.
13. McDaniel, P.R. and Ault, H.J., *Introduction to United States International Taxation* (2d edition), Kluwer, Deventer, the Netherlands, 1981 (hereinafter "*Introduction*") at 128.
14. The legislation also added IRC, Sec. 1248 which was designed to prevent avoidance of the ordinary tax rates by liquidating the controlled foreign corporation or selling the stock. In general, Sec. 1248 provides that the gain on the disposition of stock in a controlled foreign corporation, which would otherwise be treated as a capital gain, must be reported as ordinary income.
15. *Introduction* at 118.
16. Harvard at 362.
17. There are various reasons why the U.S. Congress did not attempt to tax the foreign corporations directly. For example, there could be serious problems under international law as well as practical problems if the corporation has some foreign shareholders. See Bittker, B.I. and Eustice, J.S., *Federal Income Taxation of Corporations and Shareholders* (4th ed.), Warren, Gorham, and Lamont, Boston and New York, 1979 (hereinafter "Bittker") at 17-61. See also *Fundamentals* at 65.
18. Harvard at 362.
19. *Introduction* at 129. In 1976, some U.S. Senators favored an amendment, which was only narrowly defeated, that would have applied Subpart F to all controlled foreign corporations. The complete termination of tax deferral was also proposed by former U.S. President Jimmy Carter as part of his 1978 Tax Program. Id.
20. IRC, Sec. 951(a).
21. IRC, Sec. 957(a).
22. IRC, Sec. 7701(a)(30).
23. IRC, Sec. 951(b).
24. House Report at 59; *Fundamentals* at 67.

entity,[25] and broad attribution rules are used for determining ownership for purposes of the 50% and 10% voting power requirements.[26] Only U.S. shareholders are subject to tax under Subpart F, and each such shareholder is taxed only with regard to the stock that he owns directly or indirectly.[27]

A foreign corporation's status as a CFC for the requisite period of time does not in itself trigger taxation under Subpart F. The U.S. shareholders are taxed only if the CFC derives "tainted" income, engages in certain conduct, or makes certain investments during the taxable year. The following outline shows the kinds of income, activities, and investments that result in taxation under Subpart F.[28]

I. The sum of A, B, and C
   A. Subpart F income, defined as
      1. Income from insuring U.S. risks,
      2. Foreign base company income, defined as
         a. foreign personal holding company income,
         b. foreign base company sales income,
         c. foreign base company services income,
         d. foreign base company shipping income, and
         e. foreign base company oil related income,
      3. Income from boycott related activities, and
      4. Amounts paid as bribes, kickbacks and other illegal payments,
   B. Previously excluded Subpart F income withdrawn from investment in less developed countries, and
   C. Previously excluded Subpart F income withdrawn from foreign base company shipping operations, and
II. The CFC's increase in earnings invested in U.S. property.

As the outline indicates, foreign personal holding company income (hereinafter "FPHCI") as 1 kind of foreign base company income which, in turn, is 1 of the 4 components of Subpart F income.

The foreign base company income provisions are aimed at income derived by a foreign base company which, in general, is a "base" company established in a tax haven country through which the U.S. parent carries on business activities in other foreign countries.[29] Companies to which these rules apply are, for example, foreign holding companies or sales and service affiliates of U.S. enterprises that are organized in a country other than the one in which the goods are manufactured or produced, in which the goods are sold to the ultimate buyer, or in which the services are performed.[30] Foreign corporations that are incorporated in the country in which their business activities are carried on are generally not affected by these provisions.

B. Foreign personal holding company income

Subpart F uses basically the same definition of FPHCI as the sections of the IRC relating to foreign personal holding companies[31] whose shareholders, like those to whom Subpart F applies, are taxed currently on the company's undistributed profits.[32] For purposes of Subpart F, FPHCI generally means passive investment income such as dividends, interest, rents, royalties, and gains from the sale of stock or securities.[33] By eliminating deferral of tax for FPHCI, Subpart F prohibits a U.S. corporation from using a CFC to accumulate the foreign profits from foreign sub-subsidiaries free of U.S. tax. For example, if a CFC receives dividends or royalties from a foreign subsidiary of a U.S. corporation, the U.S. corporation is immediately taxable on such amounts in the year received by the CFC.[34]

Subpart F contains 2 major exceptions to the above definition of FPHCI which exclude (1) income which is not, in fact, passive and (2) certain income received from a "related person" (see Section II.C., below). Under the first exception, rents and royalties do not constitute FPHCI if they are (a) derived in the active conduct of a trade or business *and* (b) received from an *unrelated* person. Also excluded under the first exception are dividends, interest and gains from the sale of stock or securities derived in the conduct of a banking, financing or similar business or derived from certain investments made by insurance companies.[35]

For example, if a CFC rents office space (in a building that it owns) to unrelated persons, the rents received by the CFC are not FPHCI if the CFC acts as the rental agent and employs a substantial staff to perform other management and maintenance functions.[36] In contrast, if the same CFC hires a real estate agent to rent the offices and manage the building, the rents are not derived in the active conduct of a trade or business and constitute FPHCI.[37] However, rents and royalties are always considered to be derived in the active conduct of a trade or business if the CFC/lessor or the CFC/licensor manufactured, produced, developed, or acquired and added substantial value to, the property which is leased or with regard to which licenses are granted, but only if the CFC regularly engages in manufacturing, producing, etc.[38]

Under the second exception, the following items of income are not considered as FPHCI if received from a *related* person: (a) dividends and interest if the related person is organized, and has a substantial part of his business assets, in the foreign country in which the CFC is organized; (b) interest received in the conduct of a bank-

25. The stock owned by a foreign entity (i.e. a foreign corporation, partnership, trust or estate) is considered as owned proportionately by its shareholders, partners, or beneficiaries. If a foreign entity is considered as owning stock because of this rule, the entity is considered as actually owning the stock for purposes of reapplying the rule. This "chain of ownership" stops with the first U.S. person. See IRC, Sec. 958(a) and IRC Regulations (hereinafter "Reg.") 1.958-1(b).
26. IRC, Sec. 959(b). The general rules applicable to corporate transactions are in IRC, Sec. 318, and they are modified somewhat for purposes of Subpart F. See Grotell, A., "Determining Controlled Foreign Corporation Status", *Subpart F – Foreign Subsidiaries and their Tax Consequences* (Feinschreiber, R., ed.), Panel Publishers, New York, 1979, at 175.
27. IRC, Sec. 951(a)(1).
28. IRC, Secs. 951-954.
29. *Introduction* at 122; *Fundamentals* at 70.
30. Bittker at 17-69.
31. IRC, Secs. 551-558. A foreign corporation is a foreign personal holding company if more than 50% of its stock is owned directly, indirectly, or constructively by 5 or fewer U.S. citizens or residents and 60% (50% in some cases) of its gross income consists of FPHCI. The ownership rules applicable in determining whether a corporation is a foreign personal holding company are different from those applicable under Subpart F.
32. If a U.S. shareholder of a foreign personal holding company is taxed under IRC, Secs. 551-558 with regard to FPHCI derived by a CFC, such income is excluded from taxation under Subpart F. See IRC, Sec. 951(d).
33. IRC, Secs. 553, 954(c).
34. Owens, E.A. and Ball, G.T., *The Indirect Credit*, Vol. II, International Tax Program, Harvard Law School, Cambridge, Massachusetts, 1979, at 15.
35. IRC, Sec. 954(c)(3).
36. Reg. 1.954-2(d)(1)(ii), Example 5.
37. Id., Example 4.
38. Reg. 1.954-2(d)(1)(ii) and (iii).

ing, financing or similar business if the related person engages in such business and if both the payor's and payee's businesses are predominantly with unrelated persons, i.e. more than 70% of gross income is from unrelated persons;[39] and (c) rents, royalties, and similar amounts for the use of, or privilege of using, property in the foreign country in which the CFC is organized.[40]

If a CFC has FPHCI that is includible in its foreign base company income because none of the above exceptions apply, the CFC has 2 other possibilities for excluding the income from Subpart F. First, if the gross amount of the CFC's foreign base company income is less than 10% of its total gross income, then no part of the gross income is treated as foreign base company income; however, if such income exceeds 70% of gross income, the entire gross income is treated as foreign base company income.[41] Secondly, foreign base company income does not include any item of income received by a CFC if it is established to the satisfaction of the U.S. tax authorities that neither the creation of the CFC in the foreign country in which it is organized nor the effecting of the transaction giving rise to the item of income has as one of its significant purposes a substantial reduction of income or similar taxes.[42]

C. Related person

Subpart F provides that a person is a related person with respect to a CFC if such person is (1) an individual, partnership, trust or estate which controls the CFC, (2) a corporation which controls, or is controlled by, the CFC, or (3) a corporation which is controlled by the same person or persons which control the CFC.[43] The requisite control exists if the person owns directly, indirectly, or constructively stock representing more than 50% of the total voting power.[44]

Under this definition, individuals, partnerships, estates or trusts are related persons *only* if they control the CFC, and *not* if they are controlled by the CFC or another person. Whether or not this result was intended is unclear, but this exclusion can be extremely important, as illustrated by the case discussed in Section III.

Classification of a foreign organization as a corporation, partnership, trust or estate can have significant consequences, not only because of the above exclusion but for other reasons as well. For example, Subpart F applies only to certain foreign *corporations*. For U.S. tax purposes, classification of a foreign organization is determined under U.S. law, and whether or not a foreign organization is considered as a corporation depends on the extent to which it has "corporate characteristics".

"Corporate characteristics" are (1) associates, (2) an objective to carry on business and divide the profits, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests.[45] Other factors may be considered as well, and a foreign organization is treated as a corporation if its "corporate characteristics" are such that the organization more nearly resembles a corporation than a partnership or trust.[46]

Foreign law is relevant in such matters as determining whether the legal relationships created in the formation of an organization are such that "corporate characteristics" exist. Thus, foreign law determines the legal relationships of the members of the organization among themselves and with the public at large as well as the interests of the members of the organization in its assets.[47]

To facilitate classification of foreign organizations, the U.S. tax authorities have prepared a country-by-country list of the kinds of business organizations in certain foreign countries and their U.S. counterparts, if any.[48]

III. A VICTORY FOR TAXPAYERS

In August 1982, the U.S. Court of Appeals for the Ninth Circuit handed down its decision in *MCA, Inc. and Universal City Studios, Inc. v. U.S.*,[49] a case involving MCA, Inc. and its wholly owned subsidiary (MCA and its subsidiary are hereinafter referred to as "MCA") and Paramount Pictures Corporation (hereinafter "Paramount"), all U.S. corporations that, in 1970, formed a Dutch corporation, Cinema International Corporation (hereinafter "CIC"), for the purpose of distributing films abroad. MCA and Paramount each owned 49% of CIC's stock, and the remaining 2% was used to fund an employee trust (hereinafter "Trust") created by MCA and Paramount for the benefit of CIC's top directors.

CIC had 8 members on its Board of Directors, 4 elected by MCA and 4 by Paramount. During the years in question, 1972-1973, MCA elected X, its chief executive officer, and Paramount elected Y, its chief executive officer, to serve on CIC's Board of Directors, and X and Y were each given authority to designate 3 additional directors. X and Y served on the Board of Trustees of Trust, which had 3 trustees, and X and Y had authority to appoint the third trustee. The third trustee was a Dutch attorney, and the Board of Trustees acted by majority vote.

After Trust was created, CIC and Trust formed local distribution outlets (hereinafter "distributorships") in 29 foreign countries, and each was owned 95% by CIC and 5% by Trust. The relationships among the various entities is shown in the following diagram:

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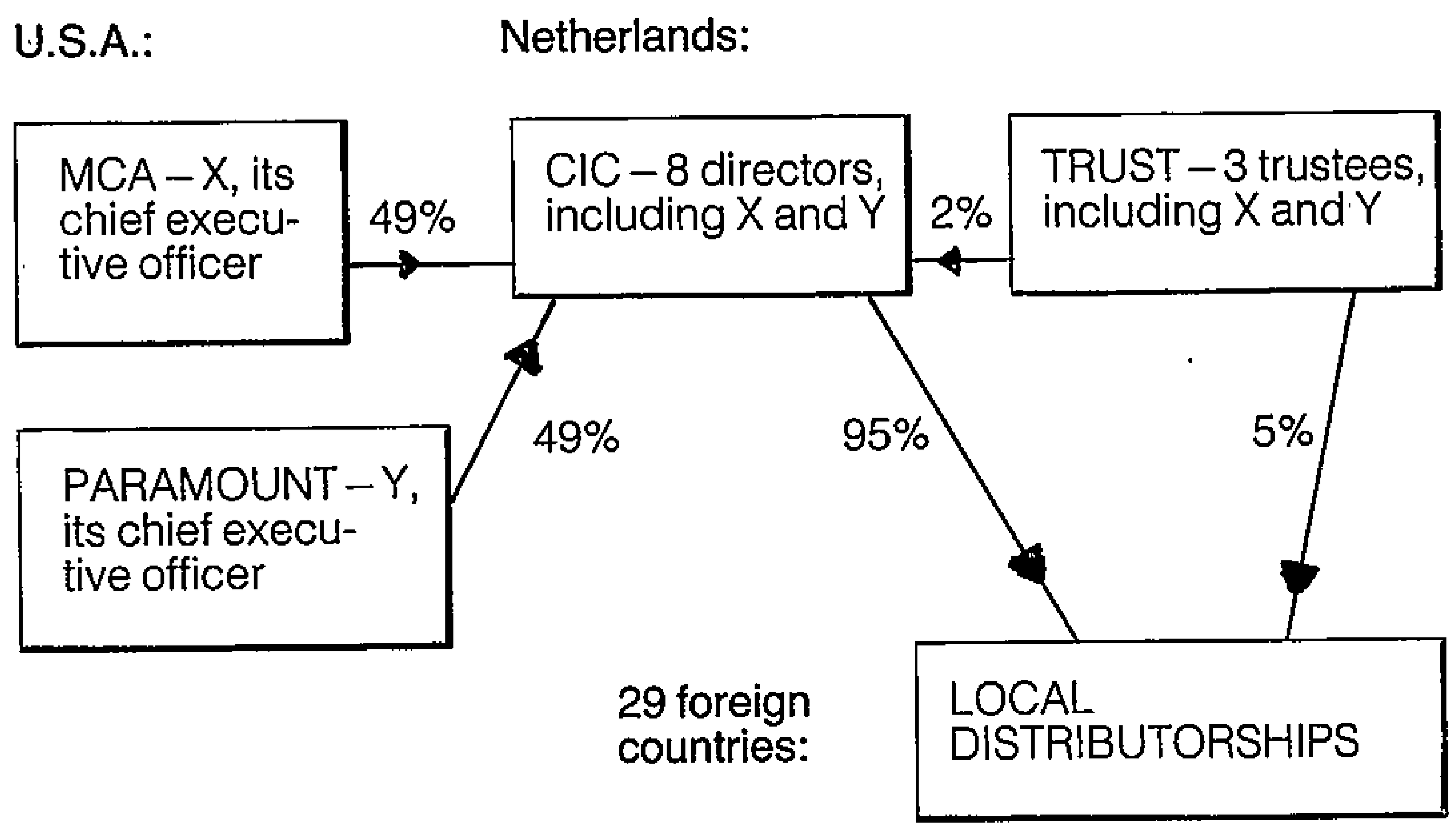
39. Reg. 1.954-2(e)(2).
40. IRC, Sec. 954(c)(4).
41. IRC, Sec. 954(b)(3). If the gross amount of foreign base company income is 10% or more, but does not exceed 70%, of total gross income, the actual amount of the foreign base company income is includable under Subpart F. Id.
42. IRC, Sec. 954(b)(4). A significant purpose is one that is important but not necessarily the principal purpose or the purpose of first importance. Reg. 1.954-1(b)(4)(iii).
43. IRC, Sec. 954(d).
44. Id.
45. Reg. 301.7701-2(a).
46. Id.
47. Reg. 301.7701-1(c).
48. Internal Revenue Service, Internal Revenue Manual – Audit, MT 4233-16, 23 April 1981, as reprinted in Harvard at 379.
49. U.S. Court of Appeals for the Ninth Circuit, No. 80-5510, 27 August 1982; 50 AFTR 2d 82-5782. The Ninth Circuit Court of Appeals is a federal appellate court to which decisions from the federal district courts in several states, including California, may be appealed.



Each of the distributorships was structured as an independent taxable entity, and the organizational documents of each included provisions designed to conform to the partnership requirement under the IRC Regulations.

CIC provided films to the distributorships and received rents and royalties from them. The issue was whether the rents and royalties were currently taxable as FPHCI in the hands of MCA and Paramount under Subpart F. It was undisputed that CIC was a CFC, but MCA and the U.S. Internal Revenue Service (hereinafter "IRS") disagreed about the taxability of the rents and royalties. They would not be taxable under Subpart F *if* derived in the active conduct of a trade or business *and* received from an *unrelated* person. At issue, therefore, was whether or not the distributorships were "related" persons vis-à-vis CIC. More specifically, the focus was on the distributorships in 12 foreign countriers since the parties stipulated that more than 70% of CIC's gross income during the years in question came from those distributorships (and thus all of CIC's income would be taxable under Subpart F if the income from the 12 distributorships constituted Subpart F income). The IRS maintained that the distributorships were related persons and assessed a deficiency of more than $850,000 against MCA.

Under the definition of "related person", each distributorship was a related person vis-à-vis CIC only if it was a *corporation.* Thus, the key question was the classification of the distributorships. MCA and the IRS agreed that, if they were properly characterized as corporations, the rents and royalties received by CIC from them was FPHCI taxable under Subpart F. They also agreed that they were not taxable as FPHCI if the distributorships were characterized as partnerships.

The Court started its analysis by noting that the tax character of an unincorporated organization is determined under U.S. law and that, to be classified as a corporation, the organization has to have at least 3 of the 4 following "corporate characteristics": limited liability, centralized management, free transferability of interests, and continuity of life. An organization with fewer than 3 of these characteristics is treated as a partnership for U.S. tax purposes.[50] Since the issue was whether the distributorships were partnerships or corporations, the Court did not consider the other 2 "corporate characteristics" because they are common to both corporations and partnerships.

MCA and the IRS stipulated that the distributorships *had* limited liability and *did not have* centralized management and that, under both the organizational documents and applicable local law, the distributorships nominally lacked the other 2 corporate characteristics. They did not have continuity of life[51] because the organizational documents and local law provided for dissolution upon the happening of specified events, including the bankruptcy of a member. Neither did the distributorships have free transferability of interests[52] because the organizational documents and local law prohibited the transfer or burdening of 1 member's interest without the consent of the other.

The IRS contended that, notwithstanding the organizational documents and local law, the distributorships had, as a matter of substance, continuity of life and free transferability of interests. The IRS relied on the "single economic interest" theory and argued that CIC and Trust, although 2 separate entities, represented a single economic interest and that Trust, as a practical matter, never acted independently of CIC. Thus, no legal significance should be given to the provisions purporting to regulate the relations between CIC and Trust by restricting the transferability of interests and providing for dissolution of the distributorships in certain situations.

The Court rejected the IRS's reliance on the single economic interest theory because CIC and Trust were beneficially owned by parties with separate and distinct economic interests. CIC was beneficially owned primarily by MCA and Paramount, and Trust was beneficially owned by individual employees of CIC. Thus, there was a potential for a legitimate conflict of interests between CIC and Trust in the management of the distributorships.

The IRS asserted that any potential for conflict was hypothetical since CIC and Trust were subject to the common control of MCA and Paramount as a result of X's and Y's roles as controlling members both of CIC's Board of Directors and Trust's Board of Trustees. The IRS pointed out that Trust's Deed granted to the trustees virtually unlimited discretion in managing and investing the trust assets, and thus X and Y, as trustees, were always free to act in conformance with the interests of MCA and Paramount and in concert with CIC.

The Court rejected the IRS's control theory because the theory ignored the trustees' duty of loyalty to Trust's beneficiaries. As trustees, X and Y had a fiduciary duty to Trust to exercise their powers in good faith and without

50. Reg. 301.7701-2(a)(3).
51. Reg. 301.7701-2(b)(1) provides that an organization does not have continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member causes a dissolution of the organization.
52. Reg. 301.7701-2(e) provides that free transferability of interests exists if each of its members (or those owning substantially all of the interests in the organization) have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In addition, there is no transferability of interests, regardless of the provisions of the organizational documents, if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new one.

concern for their own personal interests or those of third parties. According to the Court, the IRS's control theory was based on the implicit assumption that the trustees, in case of conflict, would breach their fiduciary duty and select the interests of MCA and Paramount over the interests of Trust's beneficiaries. The Court was unwilling to make this assumption. Although MCA and Paramount perhaps had gone to the brink of permissible control over Trust, the IRS had not offered any evidence that X and Y, as trustees, had gone over the brink.

The Court stated that it could not, as a matter of law, conclude that the interests of CIC and Trust would never diverge and, in the Court's opinion, the tax consequences of a legitimate business transaction should not depend on an unsupported assumption that the parties would act illegally. Therefore, the Court held that the provisions restricting the transferability of distributorship interests and limiting the continuity of distributorship life and legal effect, and as a result, the distributorships had to be classified as partnerships for U.S. tax purposes.

Finally, the IRS argued that, even if the distributorships were technically partnerships, the IRC Regulations should be construed broadly to classify them as corporations in order to eliminate an abusive form of tax shelter. Although the Court agreed that the rents and royalties derived by CIC were the kinds of income that the U.S. Congress intended to tax under Subpart F, the Court stated that it would not depart from the plain language of the statute. If there was a loophole in the Subpart F legislation, it should be corrected by new legislation, not by judicial improvisation.

INDIA – BUDGET FOR 1983/84

by Kailash C. Khanna

The Indian Budget for the year 1983-84 was presented by the Finance Minister, Mr. Pranab Mukherjee, in Parliament on 28 February 1983, when he also introduced the Finance Bill, 1983, containing his proposals relating to both direct and indirect taxation. Extracts from the Finance Minister's speech and summaries of his tax proposals have been published elsewhere in the *Bulletin*. This article pertains mainly to trade and industry's reactions to the Budget and brief comments on the proposals on direct taxes.

In his Budget speech the Finance Minister stated:

> I would, therefore, like to share with Honourable Members the philosophy of my Budget. It aims at strengthening the productive forces in the economy, keeping a tight rein on inflation, encouraging savings both in the individual and corporate sectors and promoting essential investment.

Unfortunately, the tax proposals outlined by Mr. Mukherjee do not bear out his philosophy and it would seem that taxes have been suggested on an ad hoc basis and in a vague manner. The eminent jurist and India's former ambassador to the United States of America, Mr. N.A. Palkhivala, has dubbed the Budget as "rudderless", the President of the Federation of Indian Chambers of Commerce and Industry calls it "disappointing" and the general opinion is that it is a Budget for non-development.

In the field of direct taxation, the Finance Minister has reversed the earlier trend of reducing tax rates. Both in the sphere of personal and corporate taxation, Mr. Pranab Mukherjee has proposed an increase in surcharge on income tax and corporate tax by 2.5%, thereby raising the tax burden. Of course, some relief has been given to the lower income group and the lowest rate of tax applicable to the initial slab has been reduced from 30% to 25% but the slab itself has been split into two, from 15,001 to 20,000 Rs. and from 20,001 to 25,000 Rs. The rate of 25% will apply to the lower slab only, and the present rate of 30% will continue to apply to the higher slab. For the next slab between 25,001 and 30,000 Rs. the tax rate will be raised by one percentage point from 34% to 35%; other rates of personal taxation will remain unchanged. Although the aggregate effect of the changes in personal taxation will be a slight loss of revenue, there will be an increase of about 1% to 1.5% in the tax burden on higher incomes.

As regards companies, an option has been proposed. Instead of paying the increased surcharge of 2.5%, companies may make a deposit with the Industrial Development Bank of India amounting to whole or a part of this surcharge. Companies will nevertheless be denuded of funds, thus belying the Finance Minister's remark that the corporate sector must learn to look towards a larger volume of internal generation of resources. This proposal apparently runs counter to the Finance Minister's intentions.

A minor incentive in the form of a removal of the 30% ceiling of gross total income in respect of specified savings like life insurance premia and provident fund contributions, etc. is proposed; the monetary ceiling will, however, continue. Income from specified long-term investments is at present exempt from assessment up to 9,000 Rs.; it is intended to raise this limit to an aggregate of 10,000 Rs. Likewise, the tax-free limit of gratuity is proposed to be raised from 30,000 to 36,000 Rs. with power to the Government to notify further increases as and when necessary. For salaried taxpayers the standard deduction is proposed to be raised from 5,000 to 6,000 Rs. Welcome as these reliefs are, these are too insignificant to have any material effect on personal savings and investment.

The Income-tax Act provides a number of incentives to industry for technological advancement, rural development, industrial growth, research and development, export market development and various other fields. Some large-scale enterprises took advantage of these concessions and paid no taxes.

The Finance Minister has now proposed in the Budget that such fiscal incentives and concessions shall not absorb more than 70% of the profits. This will ensure that companies pay a minimum tax on at least 30% of their profits. This is an inequitable provision which is opposed to accepted principles of corporate taxation and has come in for severe adverse comment. Without modification, the proposal, if enacted, may lead to litigation as under the existing law a statutory notice of a specified period is required before some of the tax concessions, investment allowance for instance, may be withdrawn, wholly or in part.

At present no tax on capital gains is charged in cases where the net consideration received on transfer of a long-term capital asset is invested in 7-year National Rural Development Bonds. It had been represented that this maturity period was rather long. In order to provide investment choice and with a view to ensuring that resources flow in desired directions, it is proposed to extend the exemption to cover investment of the net consideration in a new Central Government Bond of 3 years' maturity, a special series of units of the Unit Trust of India and debentures of the Housing and Urban Development Corporation with maturity periods adjusted appropriately for the interest they carry. It is unfortunate that the Finance Minister has not extended this relief to reinvestment of the net consideration in productive business assets, both movable and immovable. If necessary, a list of such assets could be prescribed.

With a view to encouraging larger exports of certain goods and merchandise, a tax concession consisting of a deduction in the computation of taxable income equivalent to 5% of the amount by which the export turnover of the accounting year exceeds the export turnover of the immediately preceding year has been suggested. The tax concession will, however, not be available in relation to export of services and facilities, and to qualify for this concession the export proceeds must be receivable in convertible foreign exchange. This means that exports to certain East European countries on a rupee basis will not be eligible for the concession.

A novel provision is intended to be inserted in the Income-tax Act whereby, irrespective of the method of accounting followed by the taxpayer, a statutory liability will be allowed as a deduction from taxable profits only in the year and to the extent it is actually paid. The reason for this insertion, according to the Finance Minister, is that under the existing law, taxpayers derive a benefit from deduction of unpaid liabilities disputed in law, the collection of which is stayed by the Courts. Payment of contributions to certain funds, even though due, is often delayed. This is a reprehensible provision, which, if implemented, will make a mess of the accounting and assessment records of taxpayers and create insurmountable difficulties for both assessees and tax collectors. Valuation of dutiable stocks will pose avoidable problems. Deductions from employees' provident and superannuation funds made towards the end of the accounting year are inevitably paid in the following year. To keep a record of such items will mean unnecessary additional work for an already overburdened administration. The real remedy lies in making special appeals to the Courts for expeditious rulings; the Commissioners should withdraw approval of those funds where actual payment has been inordinately delayed. It would be most unwise to clutter the statute with a complex provision which is against accepted legal and accounting principles.

An increase in the present depreciation rate of plant and machinery from 10% to 15% has been suggested. This will confer a limited benefit because in many cases special rates of depreciation exceeding 10% are already prescribed. It is also intended to raise the monetary limit from 750 to 5,000 Rs. in respect of plant and machinery which enjoy 100% write-off.

Mention may be made of a retrograde measure which seeks to disallow 20% of expenditures on advertisement, sales promotion and travel. Travel has been defined to include conveyance allowance to employees and perhaps also leave travel. This is unfair and will cause hardship to employees. Essential travel must be undertaken and the proposal will only enhance the sales value of products accentuating inflationary trends. Guest houses are also sought to be defined to include any accommodation for use by employees on tour. This proposal, too, is unfair; an employee cannot be guest of his employer while on duty. Moreover, employees who have to tour remote areas in tea, tobacco, rubber, etc., plantations or visit a small "mofussil" town must be suitably housed. It is unfortunate that some of these amendments are being given retrospective effect despite repeated assurance by the Government to the contrary.

Finally, reference may be made to the proposals affecting non-resident taxpayers. A recent High Court judgement held that remuneration received by a non-resident for services rendered in India could not be taxed as income in India if the liability for payment accrued outside India and the payment was actually made abroad. It is proposed to amend Section 9 of the Income-tax Act, 1961, to provide that salary payable to a non-resident for services rendered in India shall be regarded as income earned in India irrespective of the place of its accrual or payment. A further amendment is proposed in Section 9 to clarify that no income will be deemed to accrue or arise in India to a non-resident news agency or a publisher of a newspaper from activities confined to the collection of news and views in India for transmission out of India. The proposed amendment shall be retrospective from the beginning of the Income-tax Act.

Income tax at a flat rate of 25% shall be chargeable on the gross amount of interest receivable by foreign companies on loans advanced by them in foreign currency. No deduction of expenses, however, will be permitted from the interest income.

It is proposed that the amount of tax paid by the Government or an Indian concern on behalf of a foreign company in respect of royalties or fees for technical services paid under agreements approved by the Central Government will not be included in computing the total income of the foreign company. Thus, the practice of charging tax on tax is to be dispensed with.

With a view to encouraging the flow of foreign exchange remittances into India by non-resident Indian citizens and foreign nationals of Indian origin, the Bill seeks to make special provisions relating to certain incomes of such non-residents.

In the case of non-resident Indians, income derived from any "foreign exchange asset" will be charged to tax at the flat rate of 22.5% including surcharge. "Foreign exchange asset" will mean any "specified asset" acquired, purchased or subscribed to by non-resident Indians in foreign currency in accordance with the Foreign Exchange Regulation Act, 1973, and any rules made thereunder. The "special assets" will be (i) shares in an Indian company, (ii) debentures issued by a public limited company, (iii) deposits with a public limited Indian company, (iv) units of the Unit Trust of India, (v) securities of the Central Government, and (vi) any other asset which the Central Government may by notification in the Official Gazette specify in this behalf.

In computing the income of a non-resident Indian from any foreign exchange asset, no deduction will be allowed in respect of any expenditure or allowance under any provision of the Income-tax Act.

Tax at a flat rate of 22.5% will also be charged on income by way of capital gains arising on the transfer of a foreign exchange asset held by a non-resident Indian national for at least 36 months. However, if the net proceeds realised on transfer of any foreign exchange asset are reinvested or deposited by the non-resident Indian within 6 months in any other specified asset or in a Non-resident (External) Account in any bank in India or in any savings certificate notified by the Central Government for the purposes of clause (4B) of Section 10 of the Income-tax Act, the capital gains will be exempt from tax if the cost of the new asset or the amount deposited in the Non-resident (External) Account is not less than the net proceeds realised on the transfer of the foreign exchange asset. In case the cost of the new asset or the amount deposited in the aforesaid account is less than the net proceeds realised on transfer of the foreign exchange asset, the exemption from tax in respect of capital gains will be allowed in the same proportion as the cost of acquisition of the new asset or the amount of deposit bears to the net proceeds. If the new asset, including any deposit, is transferred or converted (otherwise than by transfer) into money by the non-resident Indian within 3 years from the date of its acquisition, the capital gain arising from the transfer of the original foreign exchange asset exempted from tax on the basis of the acquisition of the new asset will be deemed to be a long-term capital gain chargeable to tax in the year which the transfer or conversion (otherwise than by transfer) into money of the new asset takes place.

Where a non-resident Indian has income only from a foreign exchange asset or income by way of long-term capital gains arising on transfer of a foreign exchange asset, or both, and tax deductible at source from such income has been deducted, he will not be required to file a return of income under the Income-tax Act.

The income from foreign exchange assets and long-term capital gains arising on the transfer of such assets will be treated as a separate block and charged to tax at the flat rate of 22.5%. If the non-resident Indian has other income in India, such other income will be treated as an altogether separate block and charged to tax in accordance with the other provisions of the Income-tax Act. A non-resident Indian may also opt that the special provisions relating to the taxation of investment income and long-term capital gains at a flat rate should not apply to him. This option will be exercisable by a taxpayer by making a declaration to that effect along with his return of income for the relevant assessment year. If an option is exercised, the whole of the total income (including income from foreign exchange assets and long-term capital gains on transfer of a foreign exchange asset) will be charged to tax under the general provisions of the Income-tax Act.

It is also being provided that in the case of a non-resident Indian who becomes resident in India in a subsequent year, the special provision will continue to apply in relation to income derived from certain exchange assets. These assets are debentures and deposits with an Indian public limited company and Central Government securities. The special provisions will continue to apply in relation to these incomes until the transfer or conversion (otherwise than by transfer) into money of such assets.

Except for the tax measures relating to non-resident Indians, the Finance Minister's suggested changes in individual and corporate taxation will not achieve the aims and objectives outlined in his Budget speech. We may conclude by quoting Mr. Palkhivala again: "*the effect of the Budget will be as ephemeral as the perfume on a handkerchief*".

INDIA:

Budget 1983-84

Extracts from the Budget Speech pronounced by Mr. Pranab Mukherjee, Minister of Finance, on 28 February 1983.

. . .

Mr. Speaker, Sir, it is against the background of this review of budgetary out-turn that I place my budget proposals before hon'ble members. The budget is more than an exercise is raising revenue of financing outlays. In a planned economy, it represents a potent instrument for achieving national objectives and sustaining the pace of development through appropriate financial and fiscal policies. I would, therefore, like to share with hon'ble members the philosophy of my budget. It aims at strengthening the productive forces in the economy, keeping a tight rein on inflation, encouraging savings both in the individual and corporate sectors and promoting essential investment. The encouragement of savings has its corollary in discouraging consumption. Conspicuous consumption whether at individual or the corporate level has no place in a society such as ours. I have also taken this opportunity to review the effects of certain incentives and concessions in the tax law, and to modify them where appropriate. As we are placed now, the budget must reflect the imperatives of attaining as speedily as possible a viable external payment situation and, therefore, seek to promote exports and effect economies in imports through a judicious use of the fiscal instrument.

Within this overall framework, it has been my objective to keep the budgetary deficit for the next year relatively low. While it has been necessary to raise additional resources, I have tried to do so in a non-inflationary way and without subjecting the low and middle income groups to additional burdens.

I shall first deal with my proposals in the area of non-corporate income taxes. My aim is to provide some relief at the lower end of the slabs and specially to the salaried taxpayer. At the same time, it has been my endeavour to promote savings at the expense of consumption. With this end in view I am providing for a more liberal application of the exemptions pertaining to savings.

Individual savings promoted at the expense of consumption

Coming to my specific proposals let me begin with the unpleasant bit. I propose an increase in the surcharge in the income-tax on non-corporate taxpayers from the present level of 10% to 12.5 %. The revenue yield from this measure would be Rs. 47 crores[1] in a full year and Rs. 37.6 crores in 1983-84. This will accrue wholly to the Centre. Considering the increased burden cast on the Centre on account of additional expenditure on national security and special assistance to the states, hon'ble members will agree that this measure is justified.

Now for the good news. As a measure of relief to the salaried taxpayer. I am proposing that the ceiling of standard deduction be increased from the present Rs. 5,000 to Rs. 6,000. The revenue loss as a result of this proposal is expected to be Rs. [91] crores in a full year and Rs. 78 crores in 1983-84.

In recent years we have increased the exemption limits in respect of income-tax. It has, however, been pointed out to me, with some justification, that the tax rate in the initial slab is somewhat high. I accordingly propose to split the initial slab, and for the first slab between Rs. 15,001 and Rs. 20,000 the tax rate will be 25% instead of 30%. The present rate of 30% will, however, continue to apply [to the slab from] Rs. 20,001 to Rs. 25,000. For the next slab between Rs. 25,001 and Rs. 30,000 the rate will be raised by one percentage point to 35%. Even after the increase in rate of surcharge, individuals and certain categories of Hindu undivided families etc. in the lower income slabs will pay less tax than at present. The revenue effect of these proposals would be a loss of Rs. 35 crores in a full year and Rs. 28 crores in 1983-84.

As a measure to stimulate savings, I propose to remove the ceiling of 30% of gross total income in respect of savings in specified forms like Life Insurance, provident funds etc. while retaining the absolute monetary ceil-

1. Rs. 1 crore = Rs. 10,000,000

ings. Further, I intend widening the available media for savings by including National Savings Certificates, VI and VII issues. This would be particularly helpful to those past middle age and towards the end of their working lives who might find it difficult to take advantage of life insurance and other contractual forms of savings. The revenue loss from this measure is expected to be Rs. 15 crores in a full year and Rs. 12 crores next year.

Income derived from specified long-term investments is exempted at present upto Rs. 4,000 with an additional exemption of Rs. 2,000 for interest on securities and bank deposits for a period exceeding one year. As a measure of simplification, I propose to merge these separate exemption limits and raise it from Rs. 6,000 to Rs. 7,000. The existing separate exemption of Rs. 3,000 in respect of income from units of the Unit Trust of India will continue unchanged. As a result of these proposals the aggregate of specified investment income which is exempt from tax would go up from Rs. 9,000 to Rs. 10,000. This should help to stimulate savings further.

Hon'ble members would appreciate that in sum the effect of the above proposals would be such as not to increase the tax liability of assessees in the lower brackets of the tax scale notwithstanding the increase in the surcharge. As for the rest, as I intend surcharge primarily to affect consumption rather than savings I have sought to combine the surcharge with measures designed to increase personal savings in specified financial assets.

I propose to extend the operation of the Compulsory Deposit Scheme (Income-Tax Payers) Act, 1974, by a period of two years. At present, persons over 70 years of age are exempted from the requirement of making deposits. I propose to lower this limit from 70 to 65 years. Those who attain the age of 65 years on 1 April 1983 would be entitled to withdraw, at their [option], the balance of the deposits to their credit, on or after 1 June 1983.

At present no tax on capital gains is levied in cases where the net consideration received by transfer of a capital asset is invested on 7-year national rural development bonds. It has been pointed out to me that this maturity period is rather long. In order to provide investment choices and with a view to ensuring that resources flow into desired directions, I propose to extend the exemption to cover investment of the net consideration in a new central government bond of 3 years' maturity, a special series of units of the Unit Trust of India and debentures of the Housing and Urban Development Corporation with maturity periods adjusted appropriately for the interest they carry.

More tax relief for non-resident Indians

As I incidated earlier, I have decided to liberalise further the tax incentives in respect of non-resident Indians investing in India. I propose to levy a flat rate of tax of 20% plus surcharge on incomes derived by such persons from their specified investments in India made through foreign exchange remittances. These investments will include shares and debentures of Indian companies, units of the Unit Trust of India and government securities; long-term capital gains arising on transfer of such assets will also attract tax at the proposed flat rate. Such incomes will also not be taken into account in computing their other Indian incomes. They would not have to go through the procedures involved in submission of tax returns, provided they have no other income in India and tax at proposed flat rate has been deducted from their income. These non-residents will also have the option of paying tax at the normal rates applicable to resident taxpayers. Such investments will also be exempt from wealth-tax. Gifts of such assets made by Indian citizens and persons of Indian origin settled abroad to their relatives in India will also be exempt from gift-tax.

Strengthening of internal funds of corporations

I shall now deal with my proposals in respect of the corporation tax. Earlier in my speech I had referred to the need to accelerate investment through higher internal generation by companies and curbing conspicuous consumption. I believe that both the government and the companies can contribute towards this objective.

It has been pointed out to me by several committees and representative organisations of industry that given the rising costs of replacement and modernisation, the internal funds available with the corporate sector are inadequate. I find substance in this argument. Accordingly, I propose to increase the general rate of depreciation in respect of plant and machinery from 10% to 15%. I am also raising the monetary limit for 100% write-off from the present level of Rs. 750 to Rs. 5,000 in respect of small items of plant and machinery. The other related benefits which new investment in plant and machinery now enjoy will continue. The revenue loss on account of liberalisation of provisions relating to depreciation would be Rs. 140 crores in a full year and Rs. 112 crores in 1983-84.

Hon'ble members would recall that last year I had proposed to allow depreciation at 30% of cost of devices and systems for energy saving and for minimising environmental pollution and for conservation of natural resources. I propose to go farther and allow 100% depreciation on devices and systems for energy saving. In regard to devices and systems for minimising environmental pollution and for conservation of natural resources, I propose to raise the investment allowance from 25% to 35%.

Decentralisation of industry

To encourage industries to shift from urban areas and as a measure of decongesting our overcrowded cities and reducing pollution, the capital gains arising from transfer of buildings or lands used for the purposes of business is exempt from tax if it is used for acquiring lands or constructing buildings for the purposes of business at the new place. I propose to extend this exemption from tax to capital gain arising from transfer of machinery and plant also.

Reduction of tax on interest

I had occasion earlier to refer to the lowering of the interest rate structure. As my contribution to the relief being provided by banks and with a view to encouraging production and investment, I propose to reduce the rate of tax charged under the Interest-Tax Act to half of the prevailing rate. In respect of the chargeable interest arising after 31 March 1983, the rate of interest-tax will be reduced from 7% to 3½%. About half of the loss of Rs. 130 crores on account of this measure will be recouped by the additional tax revenue as a consequence of the lower deductible cost of borrowing to business and industry.

My other important objective in respect of the corporate tax structure is to provide incentive for higher production and exports. I am, therefore, continuing the two schemes announced last year and making them more liberal.

As regards the scheme for excess production, I will come to the details later while discussing my proposals in respect of indirect taxes.

Export schemes

In respect of exports the scheme announced by me last year provided some tax relief to exporters whose export turnover for any year exceeded that of the immediately preceding year by more than 10%. The total relief available under last year's scheme was also subject to a maximum of 10% of tax payable. I now propose to simplify and liberalise the scheme and remove both the minimum qualifying amount and limit of relief. Exporters will be entitled to deduct 5% of their incremental turnover in computing their taxable income. Thus, under the new scheme all increments in export turnover will be entitled to relief. Exports of all goods will qualify for this concession excepting a few specified items. As the new provisions will take effect from the assessment year 1983-84, the provision made last year is proposed to be deleted.

Profit-making companies must pay tax

Hon'ble members must be aware of the phenomenon of companies which are flourishing, but are paying no tax at all, or only a nominal tax. This is largely due to these companies availing of the tax incentives and concessions available under the provisions of the Income-tax Act. It has been a matter of concern to us that under our tax system several highly profitable companies are able to reduce their tax liability to zero even though they continue to pay high dividends. It seems reasonable that profitable and prosperous companies so should contribute at least a small portion of their profits to the national exchequer at a time when other and less better off sections of society are bearing a burden. I, therefore, propose to provide that fiscal incentives and concessions shall not absorb more than 70% of the profits. This would secure that companies pay a mimimum tax, on at last 30% of their profits.

Abolition of differential rates of tax for domestic companies

The differential rates of tax in the case of domestic companies depending upon the total income of the company are proposed to be removed.

As a measure of simplification, I propose to levy income tax at a flat rate of 25% on the gross amount of interest received by foreign companies on loans advanced by them in foreign currency.

The income-tax payable by companies at present bears a surcharge of 2.5% of such income-tax. I propose to raise the rate of surcharge to 5%. However, in lieu of the additional surcharge payable by them, companies will be offered the option to make deposits with the Industrial Development Bank of India under a scheme to be notified by the government. I am not taking credit for any revenue gain from this measure in the expectation that the additional surcharge would in fact be deposited by the companies with Industrial Development Bank of India. The amount so deposited should help to provide funds for modernisation and thus flow back to the corporate sector.

Streamlining of concessions

Our corporate tax structure is riddled with a large number of different kinds of deductions. While each deduction may seem to have a merit, the aggregate effect is to complicate tax administration, provide opportunities for misuse and reduce the growth of revenues. As a step towards rationalisation of this structure, I have reviewed the various deductions.

The Income-tax Act at present provides for weighted deduction of expenses incurred by a company or a co-operative society which uses products of agriculture, animal husbandry, dairy or poultry farming as raw material. The expenses in respect of which weighted deduction is allowed do not relate directly to the assessee's business. I propose to provide that such companies or co-operative societies would henceforth be entitled only to the deduction of expenses and not to the weighted deduction.

The Income Tax Act provides deductions for expenditure or contributions made by assessees for approved programmes of rural development. Ongoing programmes approved by the prescribed authority will continue to enjoy the benefits of the deduction upto the terminal date in respect of time-bound programmes and 28 February 1984 in other cases. However with a view to preventing possibility of misuse, it is proposed not to allow any further deductions on this score. It is not the intention of the government to deprive genuine rural development programmes of corporate support. The government would shortly establish a fund called the Prime Minister's fund for rural development, contributions to which would enjoy exemption under the Income-tax Act.

The special deduction allowed hitherto in respect of profits and gains from business of livestock breeding or poultry or dairy farming and from business of growing mushrooms, is proposed to be withdrawn. There is little justification for continuing this fiscal concession to these businesses, in view of the room for abuse. However, in order to encourage and strengthen primary co-operatives for oilseeds, fruits and vegetables, I propose to provide full exemptions from tax for such co-operatives as in the case of dairy co-operatives.

The tax concession in relation to horizontal transfer of technology was introduced in 1969. The objective was to discourage repetitive import of foreign technology. I find that the concession has lent itself to be used for tax avoidance. I, therefore, propose to withdraw this concession effective from assessment year 1984-85.

Hon'ble members must be aware of lavish and wasteful expenditure by trade and industry, particularly on traveling, advertisement and the like. With a view to inculcating a climate of austerity and providing a disincentive to unproductive, avoidable and ostentatious spending by trade and industry, I propose to provide that 20% of such expenditure will be disallowed in computing the taxable profits. The Income-tax Act provides for the disallowance of entertainment expenses beyond a ceiling and for total disallowance of expenses on maintenance of guest houses. I propose to define the terms "entertainment expenditure" and "guest house" to remove doubts about the correct import of these expressions. the revenue from these measures in a full year will be Rs. 50 crores and in 1983-84 Rs. 40 crores. The effect of these measures, combined with the increase in depreciation allowance, will be to provide a marked preferential tax treatment of investment as against unproductive expenditure.

Several cases have come to notice where taxpayers do not discharge their statutory liability such as in respect of excise duty, employer's contribution to provident fund, employees' state insurance scheme, for long periods of time. For the purpose of their Income Tax assessments, they nonetheless claim the liability as deduction even as they take resort to legal action, thus depriving the government of its dues while enjoying the benefit of non-payment. To curb such practices I propose to provide that inrrespective of the method of accounting followed by the taxpayer, a statutory liability will be allowed as a deduction in computing the taxable profits only in the year and to the extent it is actually paid. This would result in a revenue gain of Rs. 100 crores in a full year and Rs. 80 crores in 1983-84.

Avoidance of wealth-tax

It has come to my notice that some persons have been trying to avoid personal wealth-tax liability by forming closely-held companies to which they transfer many items of their wealth, particularly jewellery, bullion and real estate. As companies are not chargeable to wealth-tax, and the value of the shares of such companies does not also reflect the real worth of the assets of the company, those who hold such unproductive assets in closely-held companies are able to successfully reduce their wealth-tax liability to a substantial extent. With a view to circumventing tax avoidance by such persons, I propose to revive the levy of wealth-tax in a limited way in the case of closely-held companies. Accordingly, I am proposing the levy of wealth-tax in the case of closely-held companies at the rate of 2% on the net wealth represented by the value of specified assets, such as, jewellery, gold, bullion, buildings and lands owned by such companies. Buildings used by the company factory, godown, warehouse, hotel or office for the purpose of its business or as residential accommodation for its low-paid employees will be excluded from net wealth.

The sum of my proposals in respect of the corporate sector, the hon'ble members would appreciate, is to ensure that every profitable company pays some tax in the year in which profits accrue, that loopholes are plugged and the number of deductions is reduced, that more funds are available for modernisation and re-investment, that costs are reduced through lower interest charges and reduction in conspicuous expenses, and that higher production, particularly for exports, receives due encouragement.

Abuse of charities

Many charitable and religious trusts and institutions no doubt do laudable work. Unfortunately, it is also true that many are used as a medium for tax avoidance, accumulation of wealth and means of patronage and I cannot remain a disinterested spectator. It is time some steps are taken to set matters right.

The Taxation Laws (Amendment) Act, 1975 had laid down an investment pattern for trust funds, and trusts which failed to comply with this investment pattern from accounting years commencing after 31 March 1978 were liable to forfeit tax exemption. However, having regard to the practical difficulties involved and to ensure a more orderly change-over, this date was extended in 1977 by three years. As the whole gamut of the provisions relating to charitable and religious trusts was under consideration by the economic administration reforms commission, the date for the new pattern of investment was again extended last year by a further period of one year.

I have since considered the matter carefully. I see no justification for permitting investment of trust funds in business concerns, including shares of companies in the private sector. I accordingly propose to provide that all trust funds should be invested in specified modes, such as, government securities, units of the Unit Trust of India, deposits with scheduled banks, approved financial corporations, etc. Investment in immovable properties will, however, continue to be allowed. I am giving notice to all charitable and religious trusts to divest their share holdings and other investment in business concerns by 30 November 1983. However, trusts will be allowed to keep shares in companies, which formed part of the original corpus as on 1 June 1973, and bonus shares received up to that date. Some trusts carry on business on commercial lines and derive income therefrom. There is no reason why such business income should not be brought to tax. I, therefore, propose that business income of all charitable and religious trusts including those which have hitherto been exempted by notification will be brought to tax with effect from assessment year 1984-85. Trusts having business income will also be required to conform to the new investment pattern if they wish to seek tax exemption in respect of their other income.

Abolition of estate duty on agricultural land

Hon'ble members are no doubt aware that estate duty in respect of agricultural land is a state subject and that the Centre has levied estate duty on agricultural land only by virtue of resolutions passed in this regard by states enabling the Union to do so. Our experience is that the valuation of agricultural land leads to administrative difficulties and litigation. The yield from this levy has also not been significant over the past several years. Moreover, after the abolition of wealth-tax on agricultural land, including plantations, there is little practical justification for continuing the levy of estate duty on agricultural land. I, therefore, propose to remove the levy of estate duty on agricultural land. Since the Estate Duty Act can be amended only after the necessary resolutions of state legislatures, a bill for giving effect to this proposal will be introduced later.

The revenue loss on account of the reduction in interest-tax will be Rs. 104 crores next year. Taking into account the estimated recoupment of part of this loss, my corporation tax proposals will yield Rs. 104 crores next year. My proposals in regard to Income Tax will lead to net revenue accrual of Rs. 25.6 crores to the Centre next year and a loss of Rs. 28 crores to the states.

Customs duties, protection of the Indian market

I turn now to my proposals in the area of indirect taxation. Mr. Speaker, the House is aware that for some years now our balance of payments has been under strain. Despite this we have sought to maintain an import regime which provides adequate access to imported inputs such as raw material and capital goods to the priority sectors. At the same time, I would not like that our policies should be taken advantage of by exporters abroad facing difficult market conditions by selling unduly cheap in the Indian market to the detriment of Indian industry. I believe we should use the instrument of customs duties not only to help revenue collection but to support our balance of payments and industrial expansion. In framing my proposals I have also tried to minimise tax avoidance and evasion and taken care to see that the measures would not spur inflation.

Taking customs duties first, my principal proposal is to continue the auxiliary duties of customs first imposed from 1973 and since renewed annually. I propose also to raise with certain exceptions the present effective rates by 5 percentage points. The statutory rate of auxiliary duty is proposed to be kept at 50%, and the maximum effective rate at only 35%. The cushion of 15% will help take care of any need for higher duty levels which may become necessary for reasons such as support for indigenous production. Newsprint and crude petroleum would not be subject to the increase in auxiliary duty. Existing full exemption from auxiliary duties on essential items like fertilisers, kerosene, high speed diesel oil would be continued. The revenue gain as a result of this proposal would be Rs. 254.5 crores in a full year.

Chemicals

My next proposal relates to chemicals. This group of commodities is in general subject to a basic rate of customs duty at 60% ad valorem. With the significant fall in the international prices of chemicals, I believe it would be appropriate to raise the tariff rate to 100% ad valorem and the general effective rate of 70% ad valorem. Tariff rates of 40% and 100% applicable to certain groups of chemicals are also being raised on the same lines. However, pharmaceutical chemicals and drugs, insecticide, pesticide and fungicide chemicals, fertilisers, tanning substances, etc. have by and large been kept out of the purview of the proposed increase. This measure will yield Rs. 37.5 crores in a full year.

Metals

I also propose to raise the effective basic import duty on zinc metal from 45% to 55% ad valorem and that on lead metal from 40% to 55% ad valorem. The existing partial exemption from countervailing duty on lead scrap and waste is also proposed to be withdrawn. These measures will yield additional revenue of Rs. 12.8 crores in a full year, and would also improve the financial viability of indigenous producers.

Electronics

For the benefit of our electronic industry, the existing concessional basic import duty of 45% ad valorem is proposed to be extended to four more items of raw materials and components. Besides, the concessional basic import duty of 35% ad valorem in respect of capital goods is proposed to be extended to 14 more items. These steps would cost the exchequer Rs. 1.22 crores in a financial year.

Gifts and travellers

Another concession relates to bonafide gifts received from abroad by post or air freight. The existing duty-free limit for such gifts was fixed in 1968. I propose to raise the duty-free limit for bonafide gifts of food articles and medicines imported by post or as air freight, and other items imported by post to Rs. 200. This liberalisation, I am sure, would be welcomed by those who receive genuine gifts from their friends and relatives abroad. The revenue sacrifice would be Rs. 3.71 crores in a full year.

I also propose to rationalise and liberalise the provisions relating to import duties on articles of baggage which are brought by passengers returning to India. The present duty-free limit for baggage is Rs. 1000 fixed in 1978. I propose to raise this limit to Rs. 1,250 for adults with corresponding increase for minors and other categories of passengers. Keeping in mind the needs of Indian workers abroad who are generally engaged on contracts of one year and who then return to India, I propose a higher duty-free allowance of Rs. 5000 for them for used household effects with some exceptions. The rate of basic duty on the first dutiable value slab will remain 130%, while on the value in excess of the first dutiable slab it is being reduced from 300% to 200% ad valorem except for a few articles. Auxiliary duty will be in addition. The list of articles of baggage in respect of which duty-free entry will not be admissible is being shortened. I am sure these measures would reduce the rigours of customs clearance for incoming passengers. I do not anticipate any fall in revenue because of this liberalisation.

Streamlining of procedures

A few amendments to the Customs Act, 1962 are also proposed to streamline the working of the department in the field and to enable more efficient revenue collections. The changes relate mainly to the setting up of the inland container depots and provisions relating to warehousing and drawback. A fair amount of customs revenue remains blocked because of inordinately long warehousing of goods and it is, therefore, proposed to reduce the warehousing time to one year in the case of non-consumable stores and to three months for other goods. As a measure to expedite drawback payments, it is being provided that for claiming drawback it would be sufficient if the goods are enterd for export to a place outside India. The minimum amount for which a claim for drawback would be entertained is also being raised from Rs. 5 to Rs. 50.

Power is also proposed to be taken under the Customs Act for the government to fix effective rates of duty on a basis different from the one spelt out in the tariff. Thus, if the tariff rate of duty is on ad valorem basis, the government would have the power to fix effective rates of duty on the basis of weight, volume etc.

Excise duties

Sir, coming now to my proposals in respect of excise duties my objective has been primarily to mop up windfull gains where we believe they exist and to limit the incidence of additional levies on individual items to relatively small proportions, also keep for the important objective of promoting the small scale sector which has been a nursery for entrepreneurship in the country and has also helped to diffuse the concentration of economic power.

I propose to continue the levy of special excise duties in 1983-84 at the existing rates.

Cement

Cement prices, as hon'ble members are aware, have been ruling high in the markets. To mop up undue profits, I propose to raise the basic excise duty on cement from Rs. 135 to Rs. 205 per tonne for the commonly used variety of cement. The public excise duty on cement produced in mini-cement plants will also go up from Rs. 100 to Rs. 170, thus maintaining the existing duty differential of Rs. 35 per metric tonne in favour of the mini plants. The revenue gain would be Rs. 182 crores in a full year by way of central excise duties and Rs. 6 crores by way of countervailing duties on import of cement.

Central excise tariff Item 68 covers a miscellany of goods not elsewhere specified in the tariff. The rate of duty has been unchanged at 8% ad valorem from 1979. I propose to raise the rate now to 10% ad valorem. This measure is likely to yield an additional revenue of Rs. 120 crores by way of central excise duties and Rs. 60 crores by way of countervailing duties in a full year. The increase would be basically on finished goods since the raw materials and manufactured inputs covered by this tariff item will continue to be eligible for duty credit as at present. I have taken care to protect the small scale sector, as I will be monitoring later.

Textiles

I have also proposed a package of measures relating to man-made fibres, blended yarns and fabrics. Hon'ble members would recall that in my budget last year several duty changes were made to encourage the production of blends with the desirable proportions of polyester. As a further measure in this area. I now propose to give a competitive edge to polyester-cotton blended fabrics vis-a-vis polyester-viscose blended fabrics. The incidence of basic and additional duty on polyester-cotton fabrics containing more than 40% but less than 50% polyester is proposed to be reduced from 15% ad valorem to 6.5% ad valorem. These concessional rates would not, however, apply if polyester filament yarn is used. The overall incidence of duty on cotton yarn containing more than 40% but less than 50% polyester is also being reduced from Rs. 11.25 to Rs. 7.5 per kilogram. The revenue sacrifice entailed in these changes [is] Rs. 19.40 crores in a full year.

The effective duty on viscose staple fibre is being raised from Rs. 4 per kilogram to Rs. 5 per kilogram. Further, to discourage the increasing imports of this fibre. I propose to raise the import equity on ordinary viscose staple fibre from 30% to 40% ad valorem and on improved varieties of viscose staple fibre also to 40% ad valorem. The revenue gain will be Rs. 5.6 crores.

In the case of imported polyester fibre, considering the gap between its landed cost and domestic prices, it is proposed to raise the effective duty on polyester staple fibre by Rs. 9 per kilogram. This would yield Rs. 9 crores in a full year.

Polyester filament yarn is used in comparatively higher priced fabrics and I propose to raise the effective excise duty by Rs. 7.50 per kilogram on filament yarns of textile applications. This increase would be equally incident on imported filament yarn by way of higher countervailing duty. The increase would not be applicable to polyester filament yarn of 750 deniers and above by way of higher countervailing duties. The increase would not be applicable to polyester filament yarn of 750 deniers and above which open into industrial applications. The revenue gain in a full year would be Rs. 22.5 crores by way of excise duties and Rs. 5.6 crores by way of countervailing duties.

In step with the above increase, I also propose to raise the effective duty on nylon filament yarn of textile deniers by the same margin. The additional revenue yield will be Rs. 15.5 crores by way of Central excise duties and Rs. 50 lakhs[2] by way of countervailing duties in a full year.

Paper

As a measure to combat tax avoidance I propose to change the basis of duty from ad valorem to ad valorem-cum-specific rate on a few commodities. In respect of paper, while adopting an ad valorem-cum-specific rate, I propose to fix a uniform rate for printing, writing and most of the other varities of paper and paper board. The effective basic duty for kraft paper will be 10% ad valorem plus Rs. 1,810 per metric tonne and for most of the other varieties of paper and paper board, 10% ad valorem plus Rs. 1,430 per metric tonne. The existing concessional basic rate of 5% ad valorem in respect of white printing paper supplied to director general, supplies and disposals, or for educational purposes would, however, continue.

I have also reviewed the present concessions available to small paper mills. The linking of the concession enjoyed by this sector to the installed capacity of a plant has been posing some practical problems. I, therefore, propose to rationalise the concessions to this sector on the basis of quantum of clearances in a financial year. The extent of exemption is also being suitably modified which should encourage the small paper mills to increase their production substantially. Rates of duty for paper manufactured in such paper mills using uncoventional raw material will be Rs. 560, Rs. 900 or Rs. 1,120 per tonne depending on whether the clearances of paper and paper board from such mills in the preceding financial year did not exceed 3,000 tonnes, 7,500 tonnes or 16,500 tonnes respectively.

Aerated water

In regard to aerated waters it is proposed to fix specific rates of duty to replace the existing ad valorem rates. The effective basic duty for a bottle of 200 millilitres will be 5 paise for soda and 30 paise for others. The concessions available to small-scale manufacturers would continue.

Motor cars etc.

The present ad valorem rate in respect of motor cars is being converted into ad valorem-cum-specific rate. The effective rates would be based on the engine capacity and would be different for petrol driven and diesel driven cars.

In the case of tyres used in two-wheeled vehicles and tractors and tyres of specified sizes for trailers, the present basic tariff rate of 60% is proposed to be reduced to 25% which is the level of the present effective rates of duty.

Cigarettes

The House may recall that in November last the concessional rates of duty on cigarettes were withdrawn and cigarettes were made liable to pay statutory rates. The revenue realisations had been affected inter alia on account of disputes over the method of arriving at the assessable value. With a view to ending the room for uncertainty once for all I propose to fix specific rates of duty in respect of cigarettes. These rates of duty would be linked to their retail sale prices printed on the cigarette packs. Keeping in view the fact that the consumption of cheaper cigarettes is large, I have also sought to have a graded levy based on retail prices. The duty now proposed will, at the lowest slab, be Rs. 35 per thousand cigarettes. I expect that this measure would help the government to realise the revenue expected from this item. All these anti-avoidance measures would help secure revenue of the order of Rs. 50 crores which otherwise might have been avoided.

Small entrepreneurs

There have been strong representations from many quarters that the existing scheme of concession in excise duty for the small scale sector hampers continuous growth and should be liberalised. I have reviewed the matter. Under the general scheme applicable to 70 specified groups of commodities at present, manufacturers are eligible to get full duty exemption upto first clearances of Rs. 7.5 lakhs and the concessional rate of 75% of the duty payble on clearances in excess of Rs. 7.5 lakhs but upto Rs. 15 lakhs. I propose to raise the upper limit from Rs. 15 lakhs to Rs. 25 lakhs. At the same time, I propose to reduce the limit of full exemption from Rs. 7.5 lakhs to Rs. 5 lakhs. The clearances in excess of Rs. 5 lakhs upto Rs. 25 lakhs would, however, enjoy a concessional rate of duty of 75% of the normal duty payable.

Two commodity groups, namely, cosmetics and toilet preparations, and the other, refrigerating and airconditioning appliances and machinery and their parts, bear high rates of excise duty and will be deleted from the general scheme. An alternative exemption scheme has been provided for these items under which small manufacturers with total clarances upto Rs. 2.5 lakhs would be completely exempt from payment of duty and those with turnover upto Rs. 15 lakhs would pay duty at half the normal rate on the entire clearance.

As regards the exemption available to the small scale manufacturers of goods falling under tariff item 68, I propose to raise the eligibility limit of Rs. 30 lakhs by way of value of clearances in the previous year to Rs. 40 lakhs. This measure would help the small scale units to avail of the benefit of exemption while expanding their turnover. With the increase in the rate of duty from 8% to 10% which I mentioned earlier, the amount of the new concessions can go up to Rs. 3 lakhs against Rs. 2.4 lakhs till now.

For both the schemes, I propose to exclude the clearances of exempted goods, other than those exempted under small scale exemptions, from the computation of value of clearances for the purpose of determining the eligibility as well as availment of exemption from duty. The net revenue effect of all these concessions for the small scale sector will be a loss of Rs. 5 crores in a full year.

Stimulation of production

As part of the 1982 budget, I had announced an excise duty relief scheme for encouraging higher production in respect of certain specified commodity groups. I propose not only to continue the scheme but also enhance the relief in duty for excess clearances. Under the existing scheme, there is, for excess clearances, a relief of 20% of duty for items falling in certain duty rate groups and 10% for those falling in other such groups. I propose to provide incentive in two slabs instead of the present single slab. I also propose to increase the present incentive of 20% and 10% respectively to 30% and 15% for the first slab of excess clearances and to 40% and 20% for the subsequent slab. I am hopeful that industry would take advantage of this liberalisation and step up production.

2. Rs. 1 lakh = Rs. 100,000

State governments

I have also proposed a few changes which would benefit state governments. The first is in relation to coated fabrics, both cotton and man-made and flocked fabrics where additional excise duty (in lieu of sales tax) of 5% ad valorem is being proposed in addition to the duty on base fabrics. This measure would net an additional revenue of Rs. 3.4 crores in a full year. The other proposal relates to sandalwood oil in respect of which all extant exemptions are being withdrawn. The net gain from this proposal is Rs. 30 lakhs in a year.

Iron and steel

I now come to changes which do not involve any significant revenue. I propose a few changes in the tariff descriptions relating to iron and steel items which would align the central excise tariff, as far as these itemse are concerned, with the Indian Customs Tariff. The principles of classification hitherto adopted through executive instructions are being incorporated in the tariff entry itself. The tariff entries relating to iron and steel would be spelt out on a more scientific basis and the problems encountered in the matter of charging countervailing duty would also be reduced considerable. These changes would, however, be brought into effect from a subsequent date after the necessary groundwork. Till then, the present effective rates of duty would continue.

Concessions

Lest this litany of measures give the impression that the finance minister's proposals only relate to rasising revenue, let me add that where appropriate I have tried, as I will be announcing now, some concessions in excise duties.

Sugar is an important item in the family budget. I propose to reduce the duty on both "levy" and "non-levy" sugar. The present ad valorem rates are being replaced by specific rates, that is 38 paise per kilogram on "levy" sugar and 50 paise per kilogram on "non-levy" sugar. The revenue sacrific will be of the order of Rs. 21.02 crores in a full year. I have, however, taken special care to see that the amount due to the states from additional excise duty in lieu of sales tax on sugar is not affected.

Housewives in India, as elsewhere, have been complaining for some time about the rise in their expenses. As a measure of economising on their fuel bills without affecting the nutritional and, hopefully, the gastronomic value of what they cook, I propose to exempt totally pressure cookers from excise duties. They would not find someone else in their kitchens letting off steam.

With the same intention of promoting fuel economy, I propose also to exempt fully from excise duty fuel efficient kerosene stoves.

The effective basic rates of excise duty on electric bulbs up to 60 watts and fluorescent tubes are now 10% ad valorem and 30% ad valorem respectively. As a measure to reduce the prices of these items, and thus help in the effort to shed more light at lesser cost, I propose to exempt fully the former from excise and reduce the basic duty on the latter from 30% to 20% ad valorem.

In consideration of the potential of multi axled vehicles for fuel saving, I propose to reduce the effective basic duty on them from 15% to 10% ad valorem.

For the benefit of farmers, who use these fertilisers, I propose to fully exempt ammonium sulphate and calcium ammonium nitrate from excise duty, as also agricultural grade pyrites used for reclamation of alkaline soils.

Aluminum pipes used in sprinkler equipment for irrigation, which at present bear a basic duty of 16% ad valorem will also be fully exempted. Another proposal is for exemption from excise duty of internal combustion engines for agricultural sprayers and also for powered cycles.

One of the factors leading to higher prices of prepared or preserved foods, and food products is the cost of the metal containers used in their packaging. I propose to exempt these items from that part of excise duty as is relatable to the cost of such containers. This should bring about a reduction in the price of these foods to the consumer.

Skimmed milk, powder sold in packs up to one kilogram is also being fully exempted from duty as a measure to reduce its prices to consumers.

I also propose to fully exempt from duty several specified items of hospital furniture which should reduce the cost of acquiring them for the hospitals.

Excise duty concessions would cost the exchequer Rs. 35.02 crores in a full year.

There are some other proposals in respect of customs and excise duties which are relatively minor. I do not wish to take the time of the house over them.

M.B. Rao:

Double Tax Treaties between Developing and Developed Countries

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Literature on international taxation problems in the Third World countries is extremely scarce. It is good, therefore, that an Indian scholar, who also holds a high position in government, has written a book on the subject against the background of developing countries. In ten chapters the author discusses: The problem – the historical background – U.N. Group discussions – International Tax Law and National Law – Permanent establishment and business profit – Taxation of investment income – Other recommendations – Mutual agreement procedures and exchange of information – The Indian chapter, end with his Conclusion. At the end of this book, a detailed bibliography and an index are given both of which are helpful instruments for further study. The book shows the author's wide experience which he obtained in many countries. It should find its place in all tax libraries of any significance.

A Brief Review of the Indian Tax System

By Dr. Anil Kumar Jain and Inu Jain

The tax structure in many underdeveloped countries, including India, has grown up haphazardly. On the one hand it has been influenced by historical accidents, lessons from other countries and the ideas of foreign rulers, and on the other hand by the exigencies of the moment. It is true that many productive sources of revenue have been tapped, but "the systems of taxation generally have not been built on sound principles suited to the requirements of rapid economic growth".[1] A rational reorganisation of the tax system will not only be conducive to rapid economic growth but it will also enable more revenue to be raised in the long run. As Buchanan and Ellis point out, "While neither ideal equity nor optimum yield may be expected of the tax systems in many countries, the improvement of revenue systems throughout the underdeveloped world offers one of the greatest unexploited instruments of economic progress."[2]

The Union Government in India has used taxation as one of the main instruments to raise revenue and to achieve various socio-economic objectives. New taxes have been levied to form an integrated tax structure and tax rates have been increased to mobilise a large part of the income generated as a result of economic development. After Professor Kaldor suggested reforms in the Indian tax system in 1956, the direct tax structure in India has been formulated in such a way that all relevant ability indices are taxed. A taxpayer has to pay income tax (first introduced in 1860) when he earns income, he has to pay wealth tax (introduced in 1957) when he holds accumulated income, he has to pay gift tax (introduced in 1958) when he transfers that income to others and he has to pay estate duty (introduced in 1953) if he dies and leaves his accumulated income to his heirs. For some years (1957-62 and 1963-66) he also had to pay expenditure tax if he spent more than a specified amount. However, "such a multiple scheme of taxation is necessary in the interest of equity. Though all these direct taxes are taxes on spending power, the index of taxation is different in each case."[3]

Increased tax revenue in India has been made possible through increased additional taxation both at the centre and in the states. With every successive Five-Year Plan, the Central and the State Governments have mobilized more resources through additional taxation, and, except during the Annual Plans (1966-69), realizations have exceeded the original estimates. As a result, tax revenue as a percentage of national income increased from 7.1% in 1950-51 to 13.7% in 1970-71, and further to 19.9% in 1979-80. However, even today the proportion of tax revenue to national income is still relatively low in India. In 1977, whereas tax revenue formed 18.1% of the national income in India, it was 26% in Australia, 29.3% in Austria, 29.3% in Denmark, 27.2% in West Germany, 27.2% in Norway, 30% in Sweden, 29.2% in the United Kingdom and 20.1% in the U.S.A. Some Indian economists feel that the tax burden in India has almost reached the limit and there is no scope for a very substantial increase in taxation, except minor changes here and there. There is no doubt that in underdeveloped countries the masses, due to lower levels of income, are left with very little surplus after meeting their necessary requirements and therefore the limit of taxation is reached much earlier. However, it is also true that in Western countries the Government is expected to provide amenities which accrue to the people. This is the fiscal dilemma of all underdeveloped countries[4] and the Government has to work out a proper balance between the two so that the economic development of the country does not suffer.

Of the total tax revenue, indirect taxes have been contributing a larger share throughout the period since 1950-51 in the case of both Union and State Governments. In 1950-51, direct taxes contributed 37% of the total tax revenue of the Union and State Governments in India and the share of indirect taxes was 63%. The share of direct taxes declined to 30% in 1960-61 and further to 20% in 1980-81. Correspondingly, the share of indirect taxes increased to 70% in 1960-61 and further to 80% in 1980-81. Indirect taxes have continued to play an important role in the Indian tax system and they will continue to play such a role in future because direct taxes have a limited coverage on account of lower incomes. Indirect taxes provide a more effective way of reaching the semi-subsistence population. Another advantage of indirect taxes is that the burden is felt less by the taxpayers as compared to the burden of direct taxes, because in the case of indirect taxes the tax is camouflaged in the price of the product. That the importance of indirect taxes is increasing is evident from the fact that the share of indirect taxes in national income has gone up from 4.2% in 1950-51 to 7.1% in 1960-61, to 10.9% in 1970-71 and further to 16.4% in 1979-80.

Another striking feature of the Indian tax system has been that taxation as a source of revenue has been exploited more by the Union Government than the State Governments. Whereas the share of Union taxes in national income increased from 4.6% in 1950-51 to 6.7% in

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1. R.J. Chelliah, *Fiscal Policy in Underdeveloped Countries*, (1969).
2. N.S. Buchanan and H.S. Ellis, *Approaches to Economic Development*, p. 333.
3. R.N. Bhargava, *Indian Public Finance* (1969), p. 57.
4. R.N. Bhargava, *The Theory and Working of Union Finance in India* (1977), p. 273.

1960-61, to 9.3% in 1970-71 and further to 13.4% in 1979-80, the share of State taxes has increased rather slowly from 2.5% in 1950-51 to 3.4% in 1960-61, to 4.5% in 1970-71 and to 6.5% in 1979-80. This is also reflected in the fact that the buoyancy of Union taxes in India for the period 1950-51 to 1980-81 was 1.3900 and that of State taxes was 1.3353 (Table 1). This relatively slower rate of growth in tax revenue of the State Governments is partly due to the facts that relatively less elastic sources of revenue are assigned to the States in the Indian Constitution but it is also due to their reluctance to exploit more fully the agricultural sector.

Among the taxes inter se, the most important direct taxes of the Union Government are corporation tax and taxes on income other than corporation tax (Table 2). In absolute terms, revenue from corporation tax increased from Rs. 41 crores[5] in 1950-51 to Rs. 370 crores in 1970-71 and more rapidly to Rs. 862 crores in 1975-76 and to Rs. 2382 crores in 1982-83 (Budget). Although in absolute terms revenue from total taxes on income (corporation tax plus taxes on income other than corporation tax) increased from Rs. 173 crores in 1950-51 to Rs. 278 crores in 1960-61, to Rs. 1009 crores in 1970-71 and further to Rs. 4004 crores in 1982-83 (Budget), its share in total gross tax revenue of the Union Government has progressively declined from 42.8% in 1950-51 to 31.1% in 1960-61, to 26.2% in 1970-71 and further to 22.7% in 1982-83 (Budget). This decline in contribution is due to a relatively faster increase in the revenue from indirect taxes, especially Union excise duties. The increasing importance of Union excise duties is an indication that in future greater reliance will have to be placed upon this form of indirect taxation. Among the taxes levied by the State Governments, land revenue was most important before Independence. In later years it lost its importance because it is assessed at a flat rate and the rate of tax does not vary with the land area or the income therefrom. Sales tax has emerged as the largest source of revenue for the State Governments. Next in importance are State excise duties. Of late, stamp duties have also gained importance in the States' tax structure.

Progressivity is an essential feature of a modern tax system. Towards this end, both direct and indirect taxes have been made progressive in India and there was a tendency to increase the statutory marginal tax rates, at least up to 1973-74, so much so that the highest marginal rate of income tax (including surcharge) during the assessment year 1974-75 was as high as 97.7% on slabs of income exceeding Rs. 2 lakhs. However, the fact remains that the average income tax rate (ratio of total tax demanded to total income assessed) declined from 17.8% in 1951-52 to 16.0% in 1974-75 and the effective income tax rates for different income groups have been much lower than the corresponding statutory tax rates. The result has been the buoyancy of Indian taxes (comprising the effects of both an automatic increase and the increase attributable to additional taxation efforts) has been much lower than it should have been considering the additional taxation efforts made to raise revenue during the Five-Year Plans. The results of the buoyancy coefficients for the period 1950-51 to 1980-81 in respect of Union and State taxes are given in Table 1. The buoyancy for the total tax revenue works out to 1.3706 which means that over the period under review every 1% increase in national income is associated, on an average, with a 1.3706% increase in tax collections. Buoyancy of direct taxes at 1.0863 has been much lower than the buoyancy of indirect taxes which works out to 1.4706. This trend is also witnessed in both Union and State taxes separately. Among the taxes levied by the Union Government, Union excise duties have shown maximum buoyancy at 1.7785 followed by the corporation tax which has a buoyancy of 1.4792. Income tax, which has had a progressive rate schedule, has a buoyancy value of only 1.0443. Among the State taxes, sales tax has the highest buoyancy of 1.7541, followed by the entertainment tax (1.5664). The buoyancy of agricultural income tax and land revenue is only 0.9058 and 0.4531 respectively. Some of the important factors which have contributed to the relatively lower progressivity of the Indian taxes are: frequent amendments, relatively favoured treatment accorded to the agricultural sector, various exemptions, allowances and deductions, evasion and avoidance of taxes, multiple taxation of commodities and above all inefficient administration of both Union and State taxes which has led to problems of arrears of assessment and collection resulting in lower realizations.

During the period of planned economic development in India, the Government has tried to make the tax system integrated and broad-based. However, changes in various tax measures have been introduced in such a hurry that: "A measure undertaken under the influence of one motive tended to get annulled or modified in order to accommodate the other."[6] That our tax system has become very complicated is itself proved by the fact that a number of committees and commissions has reviewed our tax structure at short intervals. No sooner were the recommendations of one committee or commission implemented than it was again realised that the tax system had become unnecessarily complicated and there was need for further reform. In 1968, Mr. Bhoothalingam felt that, "More often than not new taxes or other types of fiscal changes are introduced to subserve the needs of the moment and are grafted on to the existing body without enough regard for compatibility or consistency."[7] The Indian Income Tax Act is a glaring example of the rapidity with which changes have been introduced. It was due to considerable criticism by courts and commentators against frequent amendments that the Income Tax Act, 1922 was replaced by the 1961 Act and it was hoped that the new Act would bring some stability to the income tax legislation. However, that hope has been belied by subsequent amendments. The total number of amendments between 1962 and 1966 came to nearly 400 and exceeded the total number of amendments made during the 18-year period from 1944 to 1961. The situation in this regard has worsened further and, during the 15-year period from 1961 to 1976, the Income Tax Act, 1961 has suffered more than 560 insertions, 600 substitutions and 190 omissions,[8] in addition to a number of

5. 1 crore = 10,000,000; 1 lakh = 100,000.
6. R.J. Chelliah, note 1, p. 161.
7. S. Bhoothalingam, *Final Report on Rationalization and Simplification of the Tax Structure* (1968), p. 17.
8. Kanga and Palkhivala, *The Law and Practice of Income Tax* (1976), preface.

changes made in the Income Tax Rules. These frequent amendments, together with inadequate facilities and programmes, have made it difficult for the general public to understand the law and abide by it. Professor R.J. Chelliah[9] is right when he observes that "there can be no doubt that if more attention had been paid to obtaining increases in revenue from the existing major taxes which had come to stay and to making suitable alterations in the tax structure with a view to making it more income elastic, several of the rate increases and ad hoc measures of taxation, especially during the sixties, could have been avoided". An almost similar situation prevails with respect to Union excise duties and sales tax. In excise taxation, a wide differentiation in rates between wage goods, luxury goods, and intermediate and capital goods is witnessed and within each sector the rate differential is quite pronounced. In 1973-74, more than 2500 rates could be counted for 66 commodities, and in the case of cotton fabrics alone there were as many as 300 rates. Each Annual Finance Act makes a large number of changes in the field of excise taxation. These frequent changes in rates have an unsettling effect on producers, consumers and tax administrators.[10] The Central Excise Reorganization Committee (1963) also criticised this policy of frequent changes and observed that, "we have also noticed that even in regard to established exercises, ad hoc adjustments and selective changes are being constantly made. . . . we have not been convinced of their necessity, in any event at such frequent intervals".[11]

A serious shortcoming of the Indian tax system has been that differential tax treatment has been accorded to the agricultural and non-agricultural sectors which has violated the principle of horizontal equity. Under the Indian Constitution, only the State Governments are empowered to tax agricultural income and the exclusion of agricultural incomes from the ambit of central income tax, which was first introduced in 1886, continues to this day. This exclusion has encouraged the business community to attribute a large slice of their non-agricultural income to incomes originating in the agricultural sector and has, therefore, encouraged large scale evasion of income tax. This anomaly has partly been rectified by the scheme of "partial integration" introduced by the Finance Act 1973. Under this scheme, agricultural income of a taxpayer is included in non-agricultural income for determining the rate of tax on non-agricultural income. Non-agricultural income up to the exemption limit is put in the first slab, agricultural income is put in the middle bracket and the balance of the non-agricultural income is put in the upper slabs. However, agricultural income still remains untaxed and we feel that the interest of equity agricultural income should be brought under the purview of the Central Income Tax. "Such a step would ensure equity in taxation, prevent splitting of non-agricultural incomes, provide increased revenue to the Government and regulate the inter-sectoral flow of resources."[12] The State Governments should surrender their right to tax agricultural income to the Central Government as they have done in the case of estate duty on agricultural land. "The States would, in fact, benefit from it because Central Government has the necessary administrative ability and experience to administer the tax. It would also ensure States' autonomy because the proceeds from the tax on agricultural income would be distributed among the States in proportion to the agricultural income assessed in each State."[13]

On the one hand, agricultural incomes have been excluded from the ambit of central taxation, while on the other the State Governments have not utilised this source of revenue in a satisfactory manner. It is unfortunate that agricultural income tax is levied only in some States, e.g. Bihar, Assam, Bengal, Orissa, Uttar Pradesh, Madras, Karnataka and Maharashtra. Even among the States which levy agricultural income tax, the exemption limits as well as the rates vary considerably and there is abundant evidence to show that the agricultural sector is inadequately taxed.[14] One of the consequences of inadequate taxation of the agricultural sector has been that the tax burden on the non-agricultural sector has been relatively higher as compared to the agricultural sector. The direct taxes paid by farmers formed only 1.8% of the income originating in the agricultural sector in 1961-62. This percentage declined to 0.8 in 1966-67, 0.6 in 1971-72 and was 0.7 in 1979-80. Against this, direct taxes paid by non-farmers formed 4.8% of the income originating in the non-agricultural sector in 1961-62. This increased to 5.1% in 1966-67, to 5.2% in 1971-72 and stood at 5.5% in 1979-80. Even in the field of indirect taxes, the urban sector contributes more than the rural sector. While in the case of rural households the tax element as a percentage of per capita consumer expenditure is estimated to have gone up from 2.9% in 1953-54 to 4.4% in 1958-59 and further to 8.0% in 1963-64, in the case of urban households the corresponding tax element is estimated to have risen from 5.9% in 1953-54 to 9.3% in 1958-59, and further to 16.6% in 1963-64. According to a later study,[15] for the year 1973-74, the incidence of indirect taxation for rural households was 8.03% and for urban households it was 17.96%.

Another shortcoming of the Indian tax system, especially income tax, has been that India has been one of the highest taxed nations in the world, both in terms of personal and corporate taxation. Prior to the reduction in the marginal rates after the recommendation of the Direct Taxes Enquiry Committee (Wanchoo Committee), the highest marginal rate of personal taxation (including

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9. Kanga and Palkhivala, note 8, p. 163.
10. Walter R. Mahler, *Sales and Excise Taxation in India* (1979), p. 107.
11. *Report of the Central Excise Reorganization Committee* (1963), p. 33.
12. Anil Kumar Jain "A Note on the Concept of Income under the Indian Income Tax", 30 *Public Finance/Finances Publiques* (1975), p. 91.
13. Anil Kumar Jain, *Taxation of Income in India* (1975), p. 93.
14. See Ved P. Gandhi, *Tax Burden on Indian Agriculture* (1966); *Report of the Taxation Enquiry Commission* (1953-54) Vol. III; C.H. Hanumantha Rao, *Taxation of Agricultural Land in Andhra Pradesh* (1966); P.K. Bhargava and G.S. Srivastava, "Tax Burden on Indian Agriculture", 28 *Bulletin for International Fiscal Documentation* (1974), pp. 54-66 and 93-107; P.K. Bardhan, "Agriculture Inadequately Taxed", *Economic Weekly* (9 December 1961), pp. 1829-35; Y.K. Alagh, "Case for an Agricultural Income Tax", *Economic Weekly* (30 September 1961), pp. 1533-38; K.N. Raj, "Resources for the Third Plan; An Approach", *Economic Weekly* (January 1959), pp. 203-8; A.M. Khusro, "Taxation of Agricultural Land: A proposal", *Economic Weekly* (February 1963), pp. 275-82; M.L. Dantwala, "Agricultural Taxation: Travails of Tax Designers", *Economic and Political Weekly* (30 December 1972), pp. A-154-56; S.S. Johl, "Agricultural Taxation in a Developing economy: A Case of India", *Indian Journal of Agricultural Economics* (July-September 1972).
15. R.J. Chelliah and R.N. Lal, *Incidence of Indirect Taxation in India, 1973-74* (1978), p. 31.

surcharge) was 97.75% in India, 65% in Sri Lanka, 78.7% in Pakistan, 71.7% in the U.S.A. and 54.6% in West Germany. In the field of corporate taxation, whereas the maximum rate of tax on domestic companies was 73.7% in India (corporation tax plus surtax), it was 42.5% in Australia, 50% in Canada, 51% in West Germany, 42.5% in the United Kingdom and 48% in the U.S.A. It is often said, and to a large extent correctly, that these high rates of tax were tolerated at the higher income levels only because of considerable avoidance and evasion of tax. The reward of tax evasion in the case of an individual on income above Rs. 2 lakhs was 44% of after-tax income. Therefore, the Wanchoo Committee rightly observed that "In such a situation, honesty becomes the first casualty and not many would find it easy to resist temptation."[16] It is pleasant to note that the Finance Act, 1974 reduced the highest marginal rate of personal income taxation from 97.7% to 77%. The Finance Act, 1976 further reduced the marginal rate of tax to 66%. Subsequently, the marginal rate was increased to 72% by raising the surcharge from 10% to 20%, but it was again reduced to 66% by the Finance Act, 1980. However, a lacuna in the steep progression still persists in the income tax rate schedule. The highest rate of basic income tax of 60% is applicable for incomes above Rs. 1 lakh whereas it should apply to incomes above Rs. 2 lakhs. Further, the Finance Act, 1981 has prescribed the rate of income tax on the first slab of Rs. 15,001 to Rs. 25,000 at 30% and has raised the rate of income tax in the slab of Rs. 25,001 to Rs. 30,000 from 30% to 34% so that the tax liability of a taxpayer with net taxable income of Rs. 30,000 may remain unchanged. We feel that the initial rate of 30% is too high. Including the surcharge of 10%, the incidence of taxation is 33% in the first slab which is substantial and will encourage evasion. John F. Due has rightly observed that, "the impact of taxes at the margin must be minimised. . . . The basic rates tend to encourage additional work, the marginal rates to discourage it."[17] We therefore feel that there should be smooth progression in the rate structure.

An important feature of the Indian income tax system is that it incorporates a number of tax incentives to encourage savings, investment, exports. etc. Such a provision has been incorporated because the object of taxation in India is not only to raise revenue but also to increase production and employment and to help economic development. For this, it is necessary that taxpayers save and invest in desired channels. Two forms of incentives have been followed in India. Certain types of income and investment have been totally excluded from the purview of taxation, such as interest received on deposits in the Post Office Savings Bank, interest on capital investment bonds, provident funds and public provident funds, National Defence Certificates, etc. On the other hand, certain types of income on specified investments are either exempt to a certain extent or they are deducted from taxable income while computing total income, such as contributions towards provident funds, life insurance premia, public provident funds, the 10 or 15-year Cumulative Time Deposit Scheme, unit-linked insurance plan, etc. Similarly, 50% of the investment in the shares of new companies may also be deducted. Income from certain categories of investments such as dividends from companies and units in the Unit Trust of India, interest on bank deposits, social security certificates and compulsory deposits, etc. is exempt up to Rs. 4,000 per annum. In addition, income from units of the Unit Trust of India up to Rs. 3,000 and bank interest on deposits with a maturity of one year or more up to Rs. 2,000 are also exempt. Incentives have also been granted to promote agriculture, exports, particular industries or areas.[18] Prior to the assessment year 1968-69, these incentives were generally granted in the form of rebates from income tax but from the assessment year 1968-69 most of them have taken the form of deductions from total income. These incentives have reduced the tax burden to some extent. However, one of the main problems with these incentive provisions has been that the existing concessions benefitted mostly the high income group people as their capacity to save is more and the tax advantage to them is also greater. As we have a progressive rate structure in India and incentives take the form of deductions from total income, a taxpayer gets the benefit at the rate of tax applicable to the highest slab of income. This is clear from Table 3 which shows the percentage gross rates of return for different kinds of investment for the financial year 1982-83. The gross rate of return depends upon the slab of income in which an assessee falls. It is clear from Table 3 that the gross return is as high as 36.76% for units, 35.29% for 6-year National Savings Certificates and 29.41% for fixed deposits with banks. Even in the case of savings deposits with the Post Office where the rate of interest is only 5.5% per annum, the gross rate of return is as high as 16.18% for incomes above Rs. 1 lakh and it is profitable for a taxpayer with an annual income of more than Rs. 30,000 to keep his money in the Post Office Savings Bank rather than deposit it in banks and earn 10% interest. The result is that there is often a diversion of saving. Secondly, these tax concessions have made the effective tax rates much different from the stationary rates and the pity is that "the differential operates regressively in favour of the high income groups as against low income groups".[19] Thirdly, in many cases concessions on more than one basis are granted for an investment.[20] For example, part of the money invested in 10 and 15-year Cumulative Time Deposit Accounts with the Post Office and provident fund contributions is excluded from taxable income. In addition, interest and bonus on such deposits is excluded from taxable income and the balances in the accounts are also excluded from taxable wealth. The Wealth Tax Act, prior to the changes made in 1971-72, contained a long list of exemptions. A person could keep wealth in different forms in joint names up to Rs. 5.5 lakhs and yet pay no wealth tax, although the nominal exemption limit was only Rs. 1 lakh. Finally, these incentive provisions have been subjected to frequent changes. It has often been seen that incentives, once introduced, do not remain in force for many years. Either they are replaced by some other incentives or they are changed within a short span

16. *Direct Taxes Enquiry Committee Final Report* (1971), p. 19.
17. Quoted in the *U.N. Report of the Second Inter-Regional Seminar on Development Planning* (September 1966), p. 81.
18. For details, see Anil Kumar Jain, note 13, Chapter 6. Provided the income from bank deposits, dividends, etc. exceeds Rs. 6,000 in a year.
19. I.S. Gulati, "Growth Oriented Budget: An Analysis of Major Suggestions", *Economic and Political Weekly* (March 1976), p. 419.
20. Usha Bishnoi, *Union Taxes in India* (1980), pp. 171-3.

of their operation. This creates uncertainty in the minds of savers and investors. Hence, we feel that incentives, once announced, should continue for a long period of time unless the circumstances warrant their earlier withdrawal. Moreover, a Tax Research Institute should be set up within the Income Tax Department to evaluate the impact of various exemptions and incentives.

The most serious problem in the income tax system, especially with respect to income tax, has been the problem of evasion and avoidance of tax. It is almost impossible to ascertain correctly the extent of tax evasion in the country because of the numerous difficulties involved in the process. Any such estimate can only be a guess and would involve an element of subjectivity until reliable data are available with respect to income generated in different sectors of the economy so as to correspond with the classification of income used in the Income Tax Act. Nevertheless some attempts have been made from time to time to measure the quantum of income evaded and the loss on account of concealment. In 1956, Professor N. Kaldor estimated that non-salary income of Rs. 576 crores evaded tax annually and tax lost was of the order of Rs. 200-300 crores. On the same pattern, the Income Tax Department placed the figure of tax evaded at Rs. 214 crores. G.S. Sahota estimated tax evasion of Rs. 61.3 crores for the year 1957-58. The latest official estimate of concealed income and tax evaded was made by the Direct Taxes Enquiry Committee (Wanchoo Committee) which estimated tax evasion at Rs. 470 crores and income concealed at Rs. 1400 crores for the year 1968-69, although Dr. D.K. Rangnekar, in his minute of dissent, estimated that the income that slipped through the tax net could be placed at Rs. 1,150 crores for 1961-62, Rs. 2,833 crores for 1968-69 and Rs. 3,080 crores for the year 1969-70. The seriousness of the problem can also be judged from the fact that more than Rs. 1,500 crores of concealed income and wealth was disclosed under the Voluntary Disclosure Scheme of 1975 and the sale of special Bearer Bonds, despite their meagre yield, has amounted to Rs. 963.88 crores (Rs. 88.66 crores in 1980-81 and Rs. 875.22 crores in 1981-82). Even if we take the Wanchoo Committee's estimate as correct and presume that the rate of growth of black money deals tallies with the rate of increase in national income (a reasonable presumption, especially in view of the fact that the evils of evasion, bribery and corruption are increasing day by day), the value of black money deals today should be around Rs. 20,000 crores. Taking income from black money deals at 20%, the total quantum of income evaded may be placed at around Rs. 4,000 crores and tax evaded at around Rs. 1,500 crores, thus testifying to the common belief that a parallel black money economy exists in our country.

Though evasion is common to all classes of citizens and all income groups, opportunities for it vary according to the nature of income earned. Opportunities are largest when income is derived from a business, profession or vocation. Modes of income tax evasion adopted by tax dodgers are varied and varying.[21] An inevitable consequence of increasing tax evasion has been that a parallel black money economy has been created in India. The black money economy has a close link with the white money economy and the users of black money can change the colour of notes from black to white by the sheer force of their genius. Unlike Gresham's law, black money does not drive out white money; instead it gets mixed up in such a way that it becomes difficult to differentiate between the two. The problem of tax evasion is also quite serious in the case of indirect taxation. The Central Excise (Self Removal Procedure) Review Committee was painfully surprised at the range, diversity and universality of evasion. It is common knowledge that production is under-recorded in factories to save excise duty and that a number of commodities are sold in the market at less than their cost plus sales tax to evade sales tax and local taxes. No doubt, slackness on the part of the officials is an important factor which has helped evasion, but it is equally true that "non-existent or dishonest supervision, unnecessary complications in tariff items and unrealistically designed exemptions provided in-built incentives for evasion".[22]

No doubt, the Union Government has taken a number of steps to check this malady but these steps have not been very successful and the problem is more serious today. It is high time that a number of steps be taken to check this malady. Suitable legal changes should be made to close the loopholes in various taxation acts, strict action should be taken against tax evaders and suitable administrative procedures should be devised to detect tax evasion. Severe tax penalties should be imposed and prosecution machinery be made more effective. In cases of proven tax evasion, cases must be taken up as a matter of right for prosecution. Wide publicity should be given to tax evaders and these people should not be given official recognition. However, it should simultaneously be ensured that there is no over-assessment or harassment of honest taxpayers.

The joint family is a very old institution in India. It is said that persons who would otherwise be prepared to continue undivided should not be driven to seek a division so as to escape or minimize taxation. It was probably for this reason and the peculiar nature of this institution that the Hindu undivided family has been treated as a distinct separate taxable entity in every Income Tax Act since the Act of 1886. However, this sacred and age-old institution of India has been used for tax avoidance in several ways.[23] There is no doubt that in some cases joint families continue because of the sentiments involved but there is also sufficient truth in the observation that, "the Hindu undivided family as a unit of assessment is retained in most cases only when it enables the persons concerned to reduce their tax liability and that in other cases, it is promptly partitioned without considerations of sentiments coming in the way".[24] In the recent past the Union Government has partly solved this problem by prescribing a separate rate schedule in respect of those Hindu undivided families which have at least one member having taxable income above the exemption limit. This problem

21. For details, see Anil Kumar Jain, "The Problem of Income Tax Evasion in India", 26 *Bulletin for International Fiscal Documentation* (1972), pp. 292-93.

22. D.T. Lakdawala, "Value-Added Tax", *The Indian Economic Journal* (Oct.-Dec. 1976), p. 201.

23. For details, see Anil Kumar Jain, "Tax Avoidance Through Hindu Undivided Family in India", 26 *Public Finance/Finances Publiques* (1974), pp. 121-30.

24. *Direct Taxes Enquiry Committee Report*, p. 75.

TABLE 1
Buoyancy estimates of selected groups of taxes for the period 1950-51 to 1980-81

Tax group	*Buoyancy coefficient*
1. All taxes	1.3706
2. Direct taxes	1,0863
3. Indirect taxes	1.4706
4. Union taxes	1.3900
5. Sales' taxes	1.3353
6. Taxes on income other than corporation tax	1.0443
7. Corporation tax	1.4792
8. Union excise duties	1.7785
9. Land revenue	0.4531
10. Sales tax *	1.7541

* Comprises general sales tax, Central sales tax, sales tax on motor spirit and purchase tax on sugar cane.

needs thorough probing. Another important method of tax avoidance in India has been the diversion of income to the spouse or minor children because tax is assessed in India on an individual basis. The seriousness of the problem of diversion of income has been recognised by a number of committees and/or commissions and the provisions of clubbing of income have been made more comprehensive in scope. It is, however, surprising that neither the Wanchoo Committee (by a majority of 3 to 2) nor the Chokshi Committee favoured the family as a unit of tax assessment. The principal argument advanced against adopting the family as the unit of assessment is that this step might disrupt the families and would put undue hardship on middle income families. However, we feel that the income of husband and wife should be clubbed together and the family should be made the unit of tax assessment. It is doubtful that adoption of this measure would lead to disruption of the institution of marriage in a country like India where the relationship

TABLE 2
Important heads of tax revenue for Union and State Governments
(rupees in crores)

Heads of revenue	*1950-51*	*1955-56*	*1960-61*	*1965-66*	*1970-71*	*1975-76*	*1980-81*	*1981-82(RE)*	*1982-83(BE)*
Union Government									
1. Corporation tax	41	37	111	305	370	862	1311	1962	2382
2. Taxes on income other than corporation tax (including States' share)	133	131	167	272	473	1214	1506	1520	1622
3. Customs	157	167	170	539	524	1419	3409	4140	4606
4. Union excise duties (including States' share)	68	145	416	898	1759	3845	6500	7501	8329
State Governments									
1. Share of Central income tax	48	55	87	123	359	734	1002	1017	1142
2. Share of Union excise duties	——	17	75	146	390	856	2777	3240	3559
3. Agricultural income tax	4	8	10	10	11	29	50	63	——
4. Land revenue	50	78	97	112	113	230	144	170	——
5. State excise duties	47	45	53	96	194	436	781	958	——
6. Stamp and registration fees	26	29	44	74	122	217	419	461	——
7. Sales tax *	60	82	159	368	755	1944	3795	4282	——
8. Taxes on passengers and goods	——	3	6	34	68	167	270	346	——

Note: In the case of State Governments' revenue receipts, the figures for 1980-81 are revised estimates and those for 1981-82 are Budget estimates.
* Comprise general sales tax, Central sales tax, sales tax on motor spirit and purchase tax on sugar cane.

TABLE 3
Percentage gross rates of return * (Financial Year 1982-83)
Slabs of income (Rs.)

	15,001–25,000	*25,001–30,000*	*30,001–50,000*	*50,001–60,000*	*60,001–70,000*	*70,001–85,000*	*85,001–100,000*	*Above 100,000*
1. Units (12.5%) **	18.65	20	22.32	27.78	29.59	31.65	34.01	36.76
2. Savings bank interest in banks (5%)	7.46	7.99	8.93	11.11	11.83	12.66	13.61	14.71
3. Savings bank interest in Post Offices (5.5%)	8.20	8.79	8.82	12.22	13.02	13.92	14.97	16.18
4. 6-year National Savings Certificates VII Issue (12%) **	17.91	19.17	21.43	26.67	28.40	30.38	32.65	35.29
5. Fixed deposits of 36 months and above with banks (10%)	14.92	15.97	17.86	22.22	23.67	25.32	27.21	29.41
6. 10-year cumulative time deposit (6.75%)	10.07	10.78	12.05	15.00	15.98	17.09	18.37	19.85
7. 15-year public provident fund (8.5%)	12.69	13.58	15.18	18.89	20.12	21.52	23.13	25.00
8. Provident fund interest (8.5%)	12.69	13.58	15.18	18.89	20.12	21.52	23.13	25.00

* Presuming that the net taxable income of the individual taxpayer exceeds Rs. 15,000.
** Presuming that the income from these sources is within Rs. 4,000 in a year.

bonds are very strong. There may be some divorces in the beginning but they will mostly be on paper. Hence, while adopting the family as the unit of assessment, the Income Tax Act may be amended to provide that even after divorce, if the inquiry reveals that couples are living together, their incomes would be aggregated for tax purposes. In order to give relief to middle and lower income families it may be provided in the Income Tax Act that the income of a wife would be clubbed with the income of the husband only when her independent income exceeds the exemption limit. Unearned income of the wife should be fully incorporated, and, with regard to earned income, deductions and exemptions permissible under the Act may also be allowed to the wife separately and only the balance added to the husband's income.

We have seen that indirect taxes contribute nearly three fourths of total tax revenue. However, problems of double and multiple taxation of commodities and the cascading effects of various indirect taxes – such as customs, excise, sales tax and octroi – which result in highly inflated prices to the consumers have been of serious concern. During the Five-Year Plans the revenue motive has been the main factor behind changes in the rates and coverage of import duties. As a result, the level of import duty in general has been much higher than was needed to give protection to domestic industries. The consumers of protected industries have hardly benefited from the policy of protection. On the contrary, "they have been forced to pay higher prices because of protection. And they continue to pay higher prices as long as the domestic price is higher than the price of the imported product exclusive of the import duty."[25] In the field of excise taxation, a large number of intermediate capital goods are indiscriminately subjected to excise duties. Since these products are subject not only to excises but also to sales tax, "the price effects of such taxation have been pervasive. Because of the pyramiding effect, the rise in prices has been more than what was strictly necessary to raise the given amount of revenue."[26] The cumulative burden at all stages works out to a very high proportion of the cost and price of the final product paid by the consumers. It is high time that these defects in direct taxes are removed and problems minimised.

25. R.J. Chelliah, note 1, p. 148.
26. Id., p. 207.

17th CIAT GENERAL ASSEMBLY:

The Impact of the Application of New Technology on Tax Administration

On 20-24 June 1983 CIAT (Centro Interamericano de Administradores Tributarios/Inter-American Center of Tax Administrators) will hold its 17th General Assembly which will be dedicated to the impact of new technology on tax administration. The host country is the Netherlands Antilles and the meetings will be held in Willemstad on the island of Curaçao.

The Assembly will consider 7 subjects, which are discussed below.

The program distributed by CIAT states that one of the conclusions of the 15th Assembly held in Mexico (1981) was that non-compliance will continue to be a serious problem for the next twenty years. For this reason, tax non-compliance was the main theme of the 1982 Paraguay Assembly. This Assembly expanded and made an in-depth study of the concepts outlined in Mexico and analyzed, among other things, the types of non-compliance and its measurement, the instruments for determining the effectiveness of measures used for counteracting non-compliance as well as sanctions and incentives.

One aspect mentioned by the General Rapporteur at Paraguay allows for relating the topic of non-compliance with the topic approved for the Netherlands Antilles Assembly to be held in 1983, which refers to the "Impact of the Application of New Technology on Tax Administration". Dr. Strassl stated then, that the effectiveness of the tax administration was the most powerful instrument available for combating tax non-compliance and to the extent the administration was effective, it would be less necessary to resort to incentives and sanctions.

This statement is, in fact, closely linked to the topic and objective approved in Paraguay for the Netherlands Antilles Assembly.

All governments face similar problems of a financial nature. The demand for public services exceeds the government's capacity to collect funds to pay for the ever rising increase in operational costs and public investment. This situation is worsened by the foreign debt of the American countries at a time when the world economy is undergoing a serious crisis and depression.

In view of this situation, the only possible long-term solution for governments seems to be the increase in productivity of resources available which, from the taxation stand point, essentially implies the increase in collections through a high level of taxpayer compliance.

This solution is applicable to both large and small countries, and everyone is aware that achieving an effective and efficient tax administration through the optimization of the resources which comprise the tax system is a very complex task.

The considerable budgetary and resource limitations common to almost all tax administrations call for seeking alternate solutions which may cause a favorable impact on the administration within a relatively short time span.

Although technological innovation is perhaps the most feasible alternate solution available to the tax administrator as it may increase the productivity of taxation offices without substantial investments, on the other hand, it must be borne in mind that the incorporation of modern technology "per se" makes no sense, since new technologies and knowledge should be used by the tax administration to the extent their application to society and the economic structure are effective.

The main purpose of the Curaçao Assembly is to analyze the benefits and problems resulting from the application of modern technology and its impact on various aspects of the administration; i.e. legal, human resources, informatics, auditing and management, as well as the great challenge presently faced by the tax administrations in order to cope with the taxpayer's technological evolution, mainly in the informatics, legislation, accounting and management areas.

Subject 1: Importance of new technology in improving tax administration

This introductory topic sets the stage for the Assembly. to this end, the speaker will discuss the effect and importance of new technology on modern organizations and society in general and the tax administration specifically. Emphasis will be on implementing new technology to increase productivity and, thus, the collection of revenues through improved decision making abilities and greater efficiency in the work place.

Subject 2: Technology applied for increasing the collection of government revenues

The collection function, perhaps the most essential function of the tax administration, comprises the assessment of the tax liability, the receipt of taxpayer payments as well as all activities which the tax administration must undertake to pursue and collect delinquent debts. It is a well known fact that within the tasks required for controlling taxpayer compliance, the effective structuring and operation of taxpayer file and current account system have proved to be valuable instruments for counteracting tax non-compliance and delinquency. On the other hand, it is evident that the application of such technology must be made in keeping with the adquate organization and must be complemented with laws that grant the administration powers to ensure the collection of the tax liability in a timely manner.

Subject 3: Technology applied for counteracting tax non-compliance

Tax non-compliance is perhaps one of the most serious and complex problems common to almost all tax administrations. In solving this problem, one of the most effective methods regularly used by the tax administration has been the auditing of taxpayers or, in other words, the set of activities aimed at controlling taxpayer compliance with their tax liabilities through the application of selective criteria for determining whether financial statements are kept in accordance with the established legal regulations.

Subject 4: Improved productivity through personnel training

Under this subject we will examine the need for training programs geared to job performance aimed at increasing productivity.

Training constitutes an important aspect of the tax administration's function, although it has not always been considered from a strictly scientific standpoint with a view to obtaining the best results. Therefore, this topic should consider an approach to training which may bring about positive results to the overall management of the tax administration.

Training for the job consists of design, delivery and maintenance of a set of learned behaviors which comprise the performance required to meet the standards or requirements of the job. To this end, the paper will discuss methods used in the design of formal classroom training programs and on-the-job training programs.

The training delivery system brings the instruction design and the trainee together in such a way that the trainee not only acquires the needed skills but is able to transfer those skills to the job in the form of required performance. Therefore, the paper will also refer to the need for close liaison between line managers and the training organization.

The training task is not complete until processes for supporting learned behaviors are implemented in the work environment. This provision for maintenance of learned behaviors is critical to the success of the training effort. To this end, the lecture will examine the need to continually evaluate training programs and some of the methods used in order to ensure that the tax administration is actually receiving the benefits expected from training.

Subject 5:
Fundamental considerations for introducing new technology

From the time the administration detects the need for change until the new technology is fully operative, there is a complete process which allows for introducing the innovation in an orderly and rational manner. In general, such process is divided into stages, i.e. diagnostic and feasibility studies, design, development and implementation, to mention only the most important ones. Each of them involves different characteristics and their timely execution is essential for the success of the innovative process, assuming that the executive as well as operational levels of the administration support such process.

The lecture and discussion of this topic in the assembly will take into account the foregoing aspect, in addition to the impact which an innovative technique will bring to the organization, such as changes in the tasks to be carried out by the officials involved, changes in the functional organic structure, additional budgetary burdens, new training programs and new problems which may arise (e.g. privacy and security of computerized information) that will require adequate handling by the administrator.

Subject 6:
Technology for measuring the effectiveness of the tax administration

Every organisation needs to measure its effectiveness in relation to its purpose. This presupposes that realistic and measurable goals have been set which may be compared with the results actually obtained.

At the 1979 CIAT Assembly held in Quito, the participants concluded that "the tax administration needs a system of evaluation in order to measure its effectiveness and such a system ought to be a function inherent to the management of a tax administration". It was also agreed on that occasion that in order to carry out such evaluation "it is indispensable to have an adequate information system which must meet the needs of the tax administration".

Mainly in the private sector, there are techniques being developed for measuring the effectiveness of the organization such as the administration by objectives and zero base budget systems, while in the public sector, we identify mainly experiences with the structure and application of performance budgeting. This topic will consider the possiblities afforded by these and other techniques for evaluating the administration management, by emphasizing its potentialities and limitations. In particular, the lecture will examine the processes and rationale used in the development of specific evaluation programs in the collection and auditing areas, by taking into account human and financial resources available, as well as the needs of the organization to ensure fulfillment of these programs. In this regard, the lecture will determine the needs and variables to be taken into account as well as the information system required for the precise measurement of effectiveness.

Subject 7:
A look at the office of the future

The modern world is entering a new era of technological changes and human challenges.

The office, as we know it today, is one of the places where the most thorough changes will occur and where these challenges will be more evident. This is due to the fact that the technology involved is changing the way of handling information in the office and that the human element is affected by the new administrative structures.

The following are some ideas on the new facilities and challenges of modern technology applied in the offices, that will serve as reference for the purposes of the lecture to be presented on this topic.

New facilities

The scope of modern electronic technology is far reaching and it has temporarily gone beyond man's ability to optimize its use.

What is actually happening is that previously separated technological developments are in a process of convergence. To point out only a few ones, we can mention: data processing, telecommunications, word processing, typesetting, duplication, microfilm and mail.

Technologies are actually undergoing such an integration process that neither the government nor private industry is capable of indicating where one ends and the other begins.

This integration is revolutionizing the handling of information inasmuch as the impact and level of productivity which an integrated information system causes on an organization is greater than that obtained if each informatics technique is operated independently.

At present, the structure of organizations in general include data processing, word processing, publications and correspondence facilities which are handled as separate organizational units. It is believed that the automated office of the mid 80's will have an administrative services center with data storage, recovery and processing facilities to support a word processing center which handles duplication, printing and publication as well as the correspondence function.

As soon as this occurs, there will appear the information manager who will keep all these recently integrated activites in operation. Nevertheless, integrated information systems do not fully develop themselves all at once. They may begin with word processing and from then on continue to develop. However, the means for integrating information are varied and not well-known. They incorporate different technologies and substantially affect all branches of an entity's organizational structure.

New challenges

The main reason why new technology has not yet had an impact on organizations is that man does not act as fast as the machines which he himself has created. This fact diminishes the capacity for developing applications for all technology presently available and much more still, for that which is in the process of development.

Other considerations which must be kept in mind for optimizing the use of the technology available are the scarce managerial knowledge about the scope and limitations of techniques such as data processing and telecommunications, which is evidenced by low budgets, and the fact that results obtained are not in proportion to the investment made.

Lastly, the advent of new technologies in information will provide alternatives, most of them very fascinating and attractive to the Tax Administrator. However, once the intitial selection is made, these alternatives will become restrictions and if this process of conversion is not handled wisely, it will probably result in a deficient administration system not readily accepted by the taxpayers and restrictive to those wishing to adapt the taxation system to the changing economies of an ever more troubled world.

Participants and Guest Observers

Directors of the Tax Administration Offices of the following countries (members of CIAT) will attend the 17th CIAT General Assembly:

Argentina, Barbados, Bermudas, Bolivia, Brazil, Canada, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Netherlands Antilles, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, United States, Uruguay, and Venezuela.

Also a number of non-member countries will send directors and other officials of Tax Administration offices as observers:

Antigua, Australia, Bangladesh, Belize, Botswana, Dominica, Egypt, Federal Republic of Germany, France, Grenada, Guyana, Indonesia, Ireland, Italy, Japan, Jordan, Liberia, Montserrat, Netherlands, New Zealand, Nigeria, Philippines, Portugal, Republic of Korea, Spain, St. Kitts, St. Lucia, St. Vincent, Sweden, Thailand, Togo, Uganda, and Zambia.

The *International Bureau of Fiscal Documentation* will be represented by Mr. Gª Caballero. Other organizations which will send representatives are:

AATA (African Association of Tax Administration), ALIDE (Latin American Association of Finance Development Institutions), Board of the Cartagena Agreement, CARICOM (Caribbean Common Market), CATA (Commonwealth Association of Tax Administrators), CEMLA (Center of Latin American Monetary Studies), CIET (Inter-American Center of Tax Studies), COTA (Caribbean Organization of Tax Administrators), ECLA (Economic Commission for Latin America), Getulio Vargas Foundation (Brazil), ICAP (Central American Institute of Public Administration), IDB (Inter-American Development Bank), IFA (International Fiscal Association), ILACIF (Latin American Insitute of Fiscal Sciences), IMF (International Monetary Fund), LAFTA (Latin American Free Trade Association Association), and Latin American Tax Law Institute).

Conference Diary

JUNE 1983

European Study Conference: Legal structure planning to protect overseas investments and assets against political risks (Seminar) (including: tax aspects of asset protection). New York (U.S.A.), June 2 and 3; San Francisco (U.S.A.), June 6 and 7 (English).

European Study Conference: Customs duties and inter-company transactions (including: analysing the burden of customs duties on inter-company transactions; case studies in tax planning for customs duties). Brussels (Belgium), June 8 (English).

Management Centre Europe: Leasing in the 80's (including: crossborder leasing - legal and tax considerations). Brussels (Belgium), June 6-8 (English).

Georgetown University Law Center: The Fifth Annual Institute on Multinational Taxation (Seminar) (including: current developments in international tax rules outside the U.S.; current developments in U.S. international tax rules: prognosis for legislative changes; new and "soon" to be concluded U.S. tax treaties; transfer pricing imbroglios; international tax plans that do or don't work). Washington (U.S.A.), June 9-10 (English).

Management Centre Europe: Taxation of international group companies and branches (including: taxation of branches; taxation of subsidiaries; taxation of shareholders; taxation of foreign currency gains and losses; domestic and tax treaty "anti-avoidance" measures). Brussels (Belgium), June 20-21 (English).

Management Centre Europe: International cash management (including: role of international tax planning in tax management). Nice (France), June 22-24 (English).

JULY 1983

Asian-Pacific Tax & Investment Research Centre: First Asian-Pacific Tax Conference. (Shangri-La Hotel) Singapore (Republic of Singapore), July 19-20 (English).

SEPTEMBER 1983

Management Centre Europe: Franchising (including: franchising abroad – money and taxation). Brussels (Belgium), September 22 and 23 (English).

OCTOBER 1983

British Branch I.F.A.: U.S./U.K. Seminar. London (United Kingdom), October 6-7 (English).

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 9-14 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre: 2, Nassim Road, Singapore 1025, tel. 235-1959. Telex rs 50257 aptirc (Republic of Singapore).

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

European Study Conference Limited: Kirby House, 31 High Street East, Uppingham, Rutland, Leics. LE15 9PY (United Kingdom).

Georgetown University Law Center, Continuing Legal Education Division: 600 New Jersey Avenue, N.W. Washington, D.C. 20001 (U.S.A.).

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).

Singapore's 1983 Budget – A Summary

by Lee Fook Hong, FCIS FAIA

The Minister for Trade & Industry, Dr. Tony Tan, presented the 1983 Budget to the Parliament of the Republic of Singapore on 4 March 1983. As expected by most Singaporeans and foreign investors, his Budget Statement was sombre and there were no tax shocks. He appealed to Singaporeans to tighten their belts and lower their expectations for wage inceases in 1983, as the world economy might or might not improve.

The first section of the Budget Statement comprised a review of the Singapore economy in 1982 and the policy of Singapore. The second elaborated on the main and development estimates for the financial year 1983 and the third on the revenue estimates and tax changes to meet the social and economic objectives of Singapore.

I

1. The economy in 1982

In his review of the progress of Singapore's economy in 1982, Dr. Tan made reference to the "Economic Survey of Singapore 1982", which was released recently, before he highlighted the performance of 1983.

He said that after 4 years of rapid growth in the region of 9 to 10% per annum, the economy of Singapore slowed down considerably last year by 6.3%. Other than construction, all major sectors of the economy were affected by the recession. Manufacturing was particularly hard-hit. Despite the general economic slowdown, Singapore was fortunate that there was full employment in 1982. However, productivity performance was poor. Productivity grew by only 2.0%, considerably lower than 5.3% achieved in 1981.

At the end of the review, the Minister said that the only real cheer for Singapore's economy in 1982 was the sharp decline in the inflation rate. The Consumer Price Index rose by 3.9%, less than half the rate of 8.2% in 1981. This increase was among the lowest in the world. Singaporeans enjoyed a smaller increase in real income in 1982. As measured by GDP per capita, real income rose by 5.1% compared to 8.6% in 1981.

2. Singapore's economic policy

After his review, the Minister elaborated on specific areas of Singapore's economic policy.

(a) Industrial development

The Minister said that industrial development in the years ahead would depend on the pace of automation and research and development. To support industrial automation, the Economic Development Board (EDB) has been expanding its training programmes in the skills required for the operation and maintenance of automated equipment. Efforts to encourage research and development (R & D) have met with encouraging success.

The Minister announced that the Science Park which had been designed to serve as a focal point for R & D activities in Singapore and to foster closer interaction between the National University of Singapore and industry would be ready for operation in 1983.

(b) Prospects

Looking ahead, the Minister urged all Singaporeans to prepare themselves for the very different economic environment that would arise from the structural changes going on in the developed countries. In particular, the push into automation and the rapid rate of technological innovation would have significant implications for Singapore's future industrial development.

To maintain Singapore's growth and competitiveness in the 1980s, the Minister urged locally-owned and managed companies to adapt to changing realities and to diversify. The EDB, through its international network, would assist local companies in making contacts with the right foreign companies. Appropriate incentives would be given to such joint venture projects involving the manufacture and development of new products.

The Minister further revealed that the EDB would also intensify its promotion of export-oriented brain services, especially those that could make full use of investment made in Singapore's technical education facilities. The Board had identified potential for Singapore in areas such as computer software, engineering design and technical services, medical testing and laboratory services. The Economic Expansion Incentives Act was originally designed in the 1960s to promote manufacturing industries. The Act would be suitably amended to encourage the development of knowledge-based services and activities involving biotechnology, microbiological production and other new technologies.

(c) Trade Development Board

The Minister reported that the Department of Trade had been reorganised into the Trade Development Board (TDB) which had been given the task of planning new trade development programmes that would assist manufacturers, particularly local ones, to establish themselves more effectively in overseas markets. The network of overseas trade offices would be expanded to help exporters seek out new market opportunities. In 1983, more trade offices would be set up as and when needed.

(d) ASEAN

On ASEAN, the Minister was happy to report that regional trade under the ASEAN Preferential Trading Arrangement (PTA) had continued to grow, in spite of difficulties in world trade.

(e) Financial services

On financial services, the Minister announced that the demand for such services in this region would continue to expand, considering that the Asia Pacific Basin had been identified as a high growth area in the coming decades. Singapore must therefore constantly upgrade the quality of its international and regional financial services to maintain the leading role. In addition to upgrading domestic banking services, the Monetary Authority of Singapore would focus on the following three major areas in the coming year for further development of Singapore as a financial centre:

– the consolidation of the gold market;
– the promotion of international loan syndication activities;
– the development of offshore fund management.

(f) Tourism

On tourism, the Minister reported that in 1982, Singapore received a total of 2.96 million visitors. This represented a sharply reduced growth of 4.5% compared to the average of 11.4% growth in the preceding 3 years.

A total of 250 conventions and 42 trade fairs were held in Singapore in 1982, slightly more than in the previous year.

(g) Computerisation

The Minister reported that following the setting up of the National Computer Board (NCB), computerisation of the Civil Service had been accelerated. The private sector had responded enthusiastically to the government's encouragement of computerisation. Dr. Tan further revealed that a key target in his plan was to make Singapore a software export centre by the end of the decade. The NCB would be looking into tax incentives and a financial assistance scheme to encourage companies to develop software packages for export.

(h) Manpower development

On manpower development the Minister emphasised the importance of manpower training which had to be carried out not only by the Government but more importantly by employers. He also urged employers to take advantage of the current slack in activity to improve the skills of the work force. He assured employers that the Skills Development Fund would be more generous in providing financial assistance.

(i) Wages

The Minister expressed hope that the switch to a new style National Wages Council (NWC) could restore to wages their true role of reflecting the productivity performance of individual industries.

(j) Productivity

The Minister reported that productivity performance last year was disappointing in comparison with recent years. The lower increase in productivity of 2.0% was, however, not surprising.

Productivity improvement in the commercial sector has been slow. He would therefore encourage non-industrial enterprises by appropriate tax incentives and other measures to automate and mechanise as rapidly as possible.

(k) Energy and water

The Minister announced that the EDB and the Public Utilities Board (PUB) were currently conducting a joint study on water usage in various establishments. He hoped that a package of incentives and disincentives to promote water conservation in commercial and industrial enterprises would be formulated soon.

(l) Construction

On construction, the Minister was happy to announce that in 1982 the construction industry was the fastest growing sector, expanding at a rate of 36% which was more than double that in 1981. With the rapid increase in output, the construction industry had improved in productivity. Last year, output per worker rose by 11.2%, a commendable result compared with the stagnation in 1981. There would be room for the industry to put in more effort to mechanise and upgrade its operations.

(m) Concluding remarks on economic policy

In his concluding remarks on economic policy, the Minister said:

"Through our expenditure programme and the tax changes, which I will cover in Parts II and III of my Statement, we will try to maintain the momentum of economic growth and, more importantly, ensure that our firms which are producing for export, or providing services to customers overseas, stand a fighting chance of winning new markets and maintaining their existing markets in the face of increasing competition.

As individuals our best contribution to Singapore's economic defence is to improve productivity at our work places. We have to tighten our belts and lower our expectations for wage increases in 1983. We should not fear the storm because we are well prepared. But we must expect rough going and, if we are unlucky, a drenching before the good times return."

II

Main and development estimates

In the second part of the Budget Statement, the Minister announced that as in 1982 the Expenditure Budget sought to achieve the following objectives:

– increase the supply of skilled, technical and professional manpower required to propel the restructuring and upgrading of the economy;
– promote infrastructural, industrial and commercial development to accelerate economic growth and restructuring; and
– intensify public housing construction to meet the de-

mand for Housing and Development Board (HDB) flats.

He then elaborated on the main and development estimates for the Financial Year 1982.

III

1. Revenue

On revenue estimates, the Minister reported,

"Income tax is still the largest single source of revenue accounting for nearly 35% of total revenue. Income tax collections for financial year 1983 are expected to reach $ 3,100 million, a fall of $ 200 million or 6.1% from financial year 1982 collections. The main reason for this decline is because the corporate sector is expected to have smaller profits. Corporate taxes account for 74% of the total income tax for financial year 1983."

2. Tax changes

After elaborating on the revenue estimates, the Minister proceeded to announce tax changes.

(a) Tax changes for individuals

The Minister proposed 3 concessions to encourage the older worker and specially qualified married women to remain in the work force and thereby contribute to Singapore's economy.

The following are extracts from the Minister's statement on tax changes:

(i) Earned income relief for taxpayers beyond the age of 55 years

In 1976 the earned income relief for individuals aged over 55 years old was increased from $ 1,000 to $ 2,000 and that for individuals aged over 60 years old from $ 1,000 to $ 3,000 as they need more money to stay healthy and continue working beyond their normal retirement age. To further encourage them to remain in the work force and to take account of the costs and pressures of the elderly in working life, I have decided to increase the earned income relief from $ 2,000 to $ 3,000 for those over 55 years old, and from $ 3,000 to $ 4,000 for those over 60 years old. The increase in earned income relief will take effect from the year of assessment 1983.

(ii) Earned income relief for handicapped persons of 55 years old and above

In 1982 the earned income relief for handicapped persons was increased from $ 1,000 to $ 2,000. However, when a handicapped person continues to work beyond the age of 55 years he can only claim the increased earned income relief either as a handicapped person or as an elderly person. It is appropriate to give recognition and encouragement to a handicapped person who continues to work beyond retirement age. I have therefore decided that such a person should be given earned income relief of $ 2,000 as a handicapped person as well as the earned income relief of $ 3,000 to $ 4,000 for continuing to work beyond the age of 55 years or 60 years, as the case may be. This tax concession will also take effect from the year of assessment 1983.

(iii) Enhanced child relief for specially qualified married women

At present, all specially qualified married women can claim enhanced child relief for up to 3 eligible children. For the first and second child, the relief is $ 2,000 or 5% of the woman's earned income and for the third child, it is $ 2,000 or 3% of her earned income, whichever is the lesser. This enhanced relief was given with effect from the year of assessment 1974 to encourage more highly qualified married women to continue to work even after they have children.

As the cost of domestic help has gone up I am improving the existing enhanced child reliefs by removing the limit placed on such reliefs but the reliefs will still be confined to the first 3 eligible children. With effect from year of assessment 1983 the enhanced child relief will be the normal child relief plus 5% of the women's annual earned income from each of the first 3 eligible children.

(b) Tax changes for companies

(i) Loan syndication

The Asia-Pacific region has been identified as a high growth area in this decade. There will consequently be greater demand for financial services in this region. In addition to providing continuing encouragement for the upgrading of domestic banking services, the Monetary Authority of Singapore is promoting international loan syndication activities as part of the further development of Singapore as an international financial centre.

The efforts made to develop loan syndication activities in Singapore include measures taken to improve the supporting infrastructure such as telecommunications, legal and printing services. A special tax holiday scheme will now be introduced to further promote loan syndication activities. Under the scheme, all income derived by the Asian Currency Units (ACUs) of banks and financial institutions in Singapore from loans syndicated in Singapore within the next 5 years beginning from 1 April 1983, and for such further period as the Minister for Finance may approve, shall be exempt from tax if the loans meet the following requirements:

(a) The lead manager is an ACU of a financial institution in Singapore. If there are two or more lead managers, at least half of that number should be financial institutions in Singapore;
(b) The Ministry of Finance is satisfied that the larger part of the whole syndication process is done in Singapore;
(c) There are at least three lenders; and
(d) The loan is an offshore loan (as defined under Section 3(a) of the Income Tax (Concessionary Rate of Tax for Asian Currency Unit Income) Regulations, 1979).

Tax exemption on income from syndicated loans will be granted on a case-by-case basis. However, there will be flexibility in the implementation of the scheme and the tax exemption will be applied to all income earned during the entire period, or tenure, of the loan.

(ii) Stamp duty on cheques and traveller's cheques

In line with our development as a financial centre, stamp duty on all cheques, including traveller's cheques, will be abolished with effect from 1 April 1983.

(iii) Tax on royalties

As an encouragement to creative talents such as authors and composers, a tax concession will be given on royalties received. With effect from year of assessment 1984, the chargeable income will be deemed to be only 10% of the royalties. However, where an author or composer is entitled to claim as deductible expenses under existing tax provisions more than 90% of the royalties (i.e. his chargeable income is less than 10%), this will continue to apply as it provides the author or composer with greater benefits. This concession will enable local publishers to offer better terms to authors and composers living in Singapore and abroad. Foreign talents will find it worthwhile to get their works published here.

(iv) First year depreciation for computers and office automation equipment

To remain competitive we must pursue efficiency relentlessly, not only in the factory but also in the office. Manufacturing enterprises are presently allowed to write off their plant and equipment over 3 years. I propose to given some encouragement to non-manufacturing enterprises to modernise their operations. With effect from year of assessment 1984 all expenditure on computers and office automation equipment can enjoy 100% depreciation in the first year. This means that expenditure on such equipment can be written off completely against taxable profits in the year following the year of purchase. If the enterprise does not have sufficient profits to take full advantage of the 100% depreciation allowance, the balance will be available for deduction in subsequent years. Residual allowance from year of assessment 1983 in respect of such equipment will also be available for full set-off in 1984. I hope that all enterprises in Singapore, both manufacturing as well as non-manufacturing, will take advantage of this concession to automate and mechanise their operations as rapidly as possible."

(c) Tax increases

The Minister then announced tax increases in the following duties:

- duties on cigarettes and tobacco;
- duties on liquors; and
- duties on petroleum products.

(d) Deduction for expenses on private hire cars

After announcing the tax increases, the Minister continued,

"There has been a marked increase in the number of private hire cars, commonly known as 'SZ' cars, in recent years. Cars are hired by companies not only for short term use by their executives but also to replace their company registered cars or 'Q' cars.

The company which hires the 'SZ' cars can claim full tax deduction for rentals and expenses while the car rental companies can claim full capital allowances on the car. If the company had purchased its own company registered car, the capital allowances would be limited to $ 35,000 and the tax deduction for expenses would be restricted to the proportion of the total expenses that the $ 35,000 bear to the capital expenditure of the car.

Although full tax deduction on expenses and capital allowances is granted only if the 'SZ' car is not rented to the same person for more than 6 months in a year, companies have circumvented this restriction by changing cars every 6 months. This arrangement confers unintended tax benefits to both the rentee company and the car rental company at the expense of revenue.

"With effect from 1 April 1983 no tax deduction will be given for the whole amount of rentals and expenses incurred in the hire if the company or business enterprise hires 'SZ' cars for periods which, in aggregate, exceed 183 days in the accounting year. If the rental periods of the 'SZ' cars overlap, the overlapping periods will be counted only once for the purpose of determining the 183-day limit."

(e) Concluding remarks

Finally, the Minister made the following concluding remarks:

"I cannot promise Members that Singapore will remain unscathed if there should be a global economic crisis triggered off by the default of a major debtor country or the failure of a large international bank. But I can say confidently that we have the resources and the determination to ensure that our physical and social fabric will not suffer permanent damage. When the storm ends, and all storms no matter how severe must end, we will emerge a fitter, stronger and better nation."

Reaction to the Budget

Employers' organisations generally expressed satisfaction with Dr. Tony Tan's Budget Statement.

The Singapore Federation of Chambers of Commerce and Industry (SFCCI) commended Dr. Tan for having brought out a "caring and sober budget".

The Singapore Manufacturers' Association (SMA) said it viewed the budget with "some measure of relief".

The Singapore International Chamber of Commerce (SICC) described it as a "strategy strictly tailored to the problems we face in 1983".

The Association of Banks of Singapore (ABS) said "the budget is quite a realistic one".

TAX CHANGES

A. Tax concessions for individuals

1. Earned income relief for taxpayers beyond the age of 55

From year of assessment 1983, earned income relief for those over 55 years old will be raised from $ 2,000 to $ 3,000 while for those aged over 60, the relief will be raised from $ 3,000 to $ 4,000.

2. Earned income relief for handicapped persons of 55 years old and above

From year of assessment 1983, handicapped workers aged 55 and above can claim both $ 2,000 earned income relief for the handicapped and the $ 3,000 or $ 4,000 relief for older workers.

3. Enhanced child relief for specially qualified married women

From year of assessment 1983, specially qualified married women who continue to work after childbirth will enjoy the normal child relief plus 5% of the annual earned income for each of the first 3 children.

B. Tax changes for companies

1. Loan syndication

All income from Asian Currency Units of banks and financial institutions in Singapore from loans syndicated in Singapore within the 5 years beginning 1 April will be exempt from tax if it meets certain requirements.

2. Stamp duty on cheques & traveller's cheques

Stamp duty on all cheques, including traveller's cheques, will be abolished from 1 April.

3. Tax on royalties

From year of assessment 1984, all chargeable income will be deemed to be only 10% of the royalties. Where the person is able to claim as deductible expenses more than 90% of the royalties, the chargeable income may even be less than 10%.

4. First year depreciation for computers and office automation equipment

From year of assessment 1984, all spending on computers and office automation equipment will enjoy 100% depreciation in the first year.

The spending on such equipment can be written off completely against taxable profits in the year after year of purchase. If a company does not have sufficient profits to take full advantage of the 100% depreciation allowance, the balance can be deducted in subsequent years.

C. Tax increases

Duties on cigarettes & tobacco

Duties on cigarettes and tobacco will be raised. Import and excise duty increases on cigarettes, cigars, cheroots and cigarillos are likely to put up prices by at least 20 cents for a 20-stick packet.

Duty on liquor

Import and excise duties on intoxicating liquors, excluding beer and stout, have been increased. This will probably add between 20 cents and $ 2 to each bottle depending on size and price. Brandy will be lightly hit with less than a dollar extra for a $ 40 bottle, but whisky, gin and rum could be $ 1.50 more. Liqueurs will be up by about $ 2.00 but champagne should be only an extra dollar.

Duties on petroleum products

With immediate effect, excise duties will be introduced on benzole and benzene at the existing import duty rate of $ 2.86 per decalitre.

D. Deductions for expenses on private hire cars

From 1 April, if a company hires SZ cars for periods adding up to more than 183 days in the accounting year, tax deduction will not be given for the whole amount of rentals and expenses incurred.

ASIAN-PACIFIC TAX & INVESTMENT RESEARCH CENTRE:

Tax Planning - Tax Avoidance - Tax Evasion

On 19 – 20 July 1983, the Asian-Pacific Investment Research Centre (APTIRC) will sponsor a conference on Tax Planning / Tax Avoidance and Tax Evasion in the Shangri-La Hotel in Singapore. The conference will be chaired by Prof. J. van Hoorn, Jr. and Mr. S. Ambalavaner, Chairman and Chief Executive of APTIRC, respectively.

The purpose of this Conference is to bring together experts from governments, business and the professions throughout South East Asia and other countries to discuss some of the most crucial issues concerning tax planning, tax avoidance and tax evasion, and highlight the relevant legal framework as well as the procedures and practices in the region with a view to:

- analysing the provisions of development-oriented laws so as to equip the top and senior management personnel with the major concepts of tax planning in the context of the existing tax positions;
- analysing the existing measures against tax evasion and avoidance;
- drawing the subtle distinctions between tax planning, legal avoidance and tax evasion;
- evaluating the positive and negative effects of taxation on policies aiming at attracting an appropriate flow of capital, goods and technology to the South East Asian countries.

The subjects and the speakers are:

Tax Avoidance in the United Kingdom: British stand on tax avoidance and tax evasion; attitude towards: tax planning - black economy - use of tax havens.
Speaker: *Alun Davies,* CBE, Barrister-at-Law (U.K.), Governor of APTIRC

Tax Avoidance and Evasion - Developments in Australia - Changing attitudes of taxpayers, revenue authorities and the courts; what is a "bona fide business arrangement" - the taxpayers' view and the revenue view, resultant growth in complexity for both the taxpayer and tax advisor; major areas of tax planning which produced specific legislative changes.
Speaker: *Ian Langford-Brown,* Tax Consultant and Partner, Deloitte Haskins & Sells, Sydney, Australia

Tax Planning in South East Asia - Tax Avoidance Measures - Summary of South East Asian taxes indicating the tax traps; and tax planning possibilities which affect regional and international operations; measures taken by the tax authorities to combat tax avoidance and tax evasion.
Speaker: *Sidney C. Rolt,* Financial Consultant (Singapore), Governor & Hon. Treasurer of APTIRC

Royalties and Withholding Taxes in Malaysia, and the Impact of Contractors Tax Imposed by Section 107A of the Income Tax Act. - Definition of royalties; sources of royalties; exempt royalties; mechanics of withholding tax; recent problems on tax treatment of royalties; interpretation of Section 107A and problems of application thereof.
Speaker: *Lee Beng Fye,* Executive Director, Price Waterhouse Services, Malaysia (Formerly Deputy Director-General of Inland Revenue, Malaysia)

Corporate Laws in South East Asian Countries vis-à-vis Foreign Investment and Transfer of Technology: Survey of fiscal and corporate laws in the region; foreign investors' viewpoint; review of corporate sector with special reference to foreign investment and inflow of technology; medium and long term prospects for investment and transfer of technology.
Speaker: *S. Irtiza Hussain,* FCA, Corporate Law Authority, Government of Pakistan, Islamabad, Pakistan; President Pakistan Institute of Chartered Accountants, Karachi

Investment in Sri Lanka by South East Asian Countries and Investment by Sri Lankan Companies in South East Asia - International transactions of loans; equity investment; royalties; technical services, marketing, management; tax treaties, tax sparing; how the financial managers can plan their investments in the context of given tax positions.
Speaker: *S. Ambalavaner,* Attorney-at-Law (Sri Lanka), Barrister-at-Law (U.K.), Governor and Chief Executive of APTIRC

Panel Discussion
Chairman: *Dr. M.P. Dominic,* Attorney-at-Law (Sri Lanka), Advocate and Solicitor (Singapore)

How the Tax Authorities in Europe are Combating Avoidance Tactics - The white, grey and black areas; domestic anti-avoidance measures in Belgium, France, Germany, the Netherlands and the United Kingdom; exchange of information: OECD, EEC, The UN Model Convention; treaty shopping.
Speaker: *Prof. J. van Hoorn, Jr.,* Chief Executive, International Bureau of Fiscal Documentation, Amsterdam, the Netherlands; Chairman of APTIRC

The Role of Fiscal Incentives in Capital Formation in Developing Countries - Economic priorities of developing countries and fiscal orientation thereof; strategy adopted in adjusting the fiscal laws with economic objectives, conflicts, if any, in making such adjustments; specific measures adopted for attracting foreign investment and transfer of technology; appraisal of the taxation measures aiming at favourable investment climate.
Speaker: *H.U. Beg,* Secretary, Ministry of Finance, Government of Pakistan, Islamabad, Pakistan

Indian Investment in South East Asia and Vice-Versa - International business transactions involving capital out-flows, transfer of technology and managerial skills; domestic tax laws and bilateral tax treaties as applicable to source income of non-residents; fiscal planning in the context of given tax positions.
Speaker: *O.P. Vaish,* Advocate (India), Chairman of International Fiscal Association IFA (India Chapter)

Tax Planning: The Role of Hong Kong and the Shape of Taxation in People's Republic of China - Analysis of legislative provisions in PRC oriented towards investment in manufacturing, trade and transfer of technology; approach of Hong Kong authorities towards tax planning and legal tax minimization; and anti-avoidance/evasion provisions of taxation laws of Hong Kong.
Speaker: *Raymond E. Moore,* Sollicitor, Hong Kong, Governor of APTIRC

New Individual Taxation System in the Philippines: - Purpose of new system of taxation; its concept; its schedular nature; simplification in administration and practice; eradicating problems of tax avoidance and evasion.
Speaker: *Angel Q. Yoingco,* Executive Director, National Tax Research Centre, Philippines, Governor of APTIRC

Indonesian Withholding Tax on Interest, Dividends and Royalties - Definition of royalties and offshore technical fees, interest and dividends; source rule; exempt fees, interest, dividends, etc.; mechanics of withholding taxes, and the problems related thereto.
Speaker: *Drs. Mansury,* Director for Direct Taxes, Directorate General of Taxes, Dept. of Finance, Jakarta, Indonesia

Panel Discussion
Chairman: *Graham R. Clark,* Senior Tax Principal, Ernst & Whinney, Singapore

The Conference fee is S$ 1,250 or US$ 625 per delegate. The Conference Organiser is: AGS Management Consultants PTE LTD, Jalan Sultan Centre, 50 Jalan Sultan # 24-05, Singapore 0719, Republic of Singapore

Colombia: Tax Amendments for 1983

By M.A. Gª Caballero

Under the state of (economic) emergency decreed by the Government in December 1982, a series of decrees have been issued which introduce important changes in domestic tax law. It is within the competence of the Supreme Court of Justice, however, to decide whether or not the measures introduced by the Government under the state of emergency are constitutional and thus applicable. The amendments introduced concern, inter alia, the following aspects of domestic tax law.

INDIVIDUAL INCOME TAX

Taxable persons and progressive income tax rates

Decree 3743/82 of 23 December 1982 introduced changes relating to taxable persons and to the income and complementary net wealth tax rate tables. According to this decree (i) taxpayers whose 1982 gross income exceeded 150,000 pesos or whose gross wealth at 31 December 1982 exceeded 450,000 pesos are required to file an income tax return; (ii) the progressive rates applicable to the average net taxable income within each income bracket run from 5% for the bracket 2,001 – 4,000 pesos, up to a maximum of 49% for net taxable income exceeding 6,140,000 pesos; and (iii) the progressive tax rates applicable to the average net wealth taxable base within each bracket run from 0.097% for the bracket 200,001 – 300,000 pesos, up to a maximum of 1.8% for taxable net wealth exceeding 43 million pesos.

This decree, however, was declared ineffective by the Supreme Court of Justice by a decision of 23 February 1983. Accordingly, Resolution 708/83 of 2 March 1983 established (i) that the amounts which are required for filing an income tax return are more than 71,000 pesos or more than 290,000 pesos, respectively, (ii) the progressive rates applicable to the net taxable income run from 10% for the first 71,000 pesos (levied on the excess over the lower limit) up to a maximum of 56% for net taxable income exceeding 2.8 million pesos, and (iii) the progressive rates of the complementary net wealth tax run from 0.6% for the excess between the lower taxable limit (i.e. 290,000 pesos which is exempt) and 570,000 pesos (upper limit), up to a maximum of 2% for net taxable wealth exceeding 8.9 million pesos.

Nevertheless, the structural changes introduced by Decree 3743/82 and rejected by the Supreme Court of Justice for the 1982 taxable year have been made effective, with amendments, for taxable year 1983 by Decree 397/83 of 10 February 1983. Accordingly, (i) resident individuals whose 1983 gross income exceeded 200,000 pesos, or whose gross wealth at 31 December 1983 exceeded 540,000 pesos are required to file an individual income tax return for 1983; (ii) a simplified method for assessment of the annual income tax liability has been introduced. Decree 397/83 contains a scale of annual net taxable incomes ranging, in increments of 2,000 pesos (the first bracket to 2,000 pesos is exempt), from a lower limit of 2,001 pesos up to net taxable income exceeding 7,370,000 pesos; these amounts represent the taxpayer's taxable base and for each 2,000 peso increment the scale indicates the tax due thereon, as well as the percentage applicable to the average net taxable income within each bracket, which runs from 5% to a maximum of 49%; taxpayers need only locate their respective net taxable base on the scale, find the corresponding tax due for such bracket and no further computations are necessary; and (iii) a similar simplified method of assessment of the complementary net wealth tax is introduced; the scale of net taxable wealth ranges, in increments of 100,000 pesos (the first 300,000 pesos are exempt), from a lower limit of 300,001 pesos up to net taxable wealth exceeding 43 million pesos; the rates run from 0.097% to a maximum of 1.8%.

The gross wealth of resident taxpayers includes property owned outside Colombia. The gross wealth of foreigners who are residents of Colombia includes property owned outside of Colombia only from the fifth year of continuous or discontinuous residence in the country.

General tables of income tax rates (withholding)

The withholding tables on earned income and on dividends were structurally amended by Decree 3819/82 of 30 December 1982. A maximum withholding rate of 39% applies on gross monthly dividends exceeding 300,000 pesos paid or credited to residents. Furthermore, resident shareholders may, if the 1982 withholdings exceed the 1982 final tax liability, offset the excess against the income tax and complementary wealth tax liabilities of 1983 and successive tax periods.

Tax amnesty

Decree 3747/82 of 23 December 1982 provides that if the net taxable income declared for 1982 is not less than the net taxable income filed for 1981, individual payers of income tax and complementary net wealth tax who did not declare property items or who declared fictitious liabilities are allowed, without incurring any fine or investigation, to include or eliminate, as the case may be, such property items or liabilities in their returns for 1982.

INHERITANCE TAX (IMPUESTO SUCESORAL) CANCELLED

Decree 237/83 of 4 February 1983 repealed the inheritance tax introduced by Decree 2143/74. Accordingly, inheritances after 4 February 1983 and inheritances already announced but for which the tax assessment has not been notified to the taxpayer by 4 February 1983 are not liable to the inheritance tax.

BASIC RULES INTRODUCED

A series of basic rules was issued by Decree 3746/82 of 23 December, as amended by Decree 399/83 of 10 February 1983. These basic rules relate, inter alia, to:

(i) Presumption of taxable income

For taxable years 1982 and 1983, a taxpayer is presumed to have as taxable income the higher of these two amounts: (i) at least 6% of the 1981 or 1982 taxable net wealth, or (ii) 1% of the 1982 receipts and 1.5% of the 1983 receipts. For the taxable year 1984, these percentages are established as 8% and 2% respectively.

(ii) Exempt capital gains

Capital gains from the alienation of fixed assets are exempt from tax, provided that (i) the book value of such assets at the alienation date plus 80% of the capital gains are reinvested in similar assets to be used in industrial or agricultural development, or are reinvested in newly issued shares or participations, or that the capital gain is allocated to the capital account through an issue of shares or participations of social interest, and (ii) the remaining 20% of the capital gain is used to acquire IFI bonds (bonds issued by the Industrial Development Institute).

(iii) Double taxation

As a unilateral measure to avoid internal double taxation of dividends, individual taxpayers resident in Colombia who are shareholders of "open" corporations (i.e. corporations with at least 100 shareholders, where at least 50% of the subscribed shares are held by shareholders who individually do not own more than 3% of the total share capital and where no shareholder (or family group) directly or indirectly through a subsidiary, a branch or close family relatives owns more than 30% of the total share capital) and whose shares are registered in a legally authorized stock market (unless a public entity or company shareholder in which case the shares must be registered in the national stock exchange), are entitled to a tax credit equal to the higher of these two amounts: either (i) 20% of the first 200,000 pesos of dividends plus 10% of the excess, or (ii) the amount resulting from applying to the gross dividend the income tax rate corresponding to the net taxable income bracket. This rate may not, however, exceed 36%.

Individual taxpayers resident in Colombia who are shareholders of corporations other than "open" ones are entitled without option to a tax credit equal to 20% of the first 200,000 pesos of dividends and 10% of the excess.

(iv) Tax incentives

Two types of incentives have been introduced, as follows:

Special tax credit

"Open" corporations are entitled to a special credit equal to 10% of the final company income tax due for the taxable year 1982. Corporations other than "open" ones are entitled to a special tax credit equal to 8% of the final company income tax due for the taxable year 1982, provided that a capital majority (i.e. at least 51%) is owned by Colombian public entities or companies, by Colombian individuals or by private companies the majority of whose capital is owned by Colombian individuals or public entities or companies.

Capitalization tax credit

"Open" corporations with Colombian majority participation which increase their capital in taxable year 1983 by issuing new shares are entitled to a capitalization credit equal to 12% of the amount by which the capital was increased. This credit, however, may not exceed 12% of the final company tax liability.

For corporations other than "open" ones, under the same conditions as above, this credit is 8% and may not exceed 8% of the company's final tax liability.

In no case, however, may the sum of all applicable credits added together exceed the final tax due.

TAXATION ON REMITTANCES ABROAD OF INCOME AND CAPITAL GAINS

Decree 231/83 of 4 February 1983 introduced a new tax, the "complementary tax on remittances abroad" (impuesto complementario de remesas), which is levied on remittances abroad of income and capital gains, irrespective of who the beneficiary or the recipient of these payments is. As of 4 February 1983 no payment abroad can take place without presenting proof that income tax, complementary net wealth tax and complementary tax on remittances abroad have been paid. The proof is to be presented to the Exchange Control Department of the Central Bank.

The complementary tax on remittances abroad is withheld at the following rates:

- at 20% for profits (other than dividends and interest from foreign loans and commissions granted to the Government and public enterprises) derived by foreign entities through a permanent establishment in Colombia, unless reinvested; for the portion which is not reinvested, unless proved to the contrary, remittance abroad is presumed to have taken place;
- at 12% for profits from participations in the capital of resident subsidiaries which are limited liability companies and assimilated, paid or credited to the account of direct foreign investors and any case other than those above.

Decree 231/83 also establishes that withholding (final) income tax on income in general and Colombian-source capital gains would be imposed, as of 4 February 1983, at the following rates:

- 40% on dividends derived by foreign entities, but a preferential rate of 20% is imposed on those dividends derived by foreign entities which have been constituted in countries or in areas where a tax treatment of dividends similar to that in Colombia is applicable;
- 40% as well on any income subject to tax in Colombia and paid or credited to the account of non-resident foreign individuals, undivided inheritances of non-resident foreigners and non-resident foreign entities.

However, payments abroad in consideration of technical assistance are not subject to withholding income tax or to complementary tax on remittances abroad, provided that:

- the beneficiary is a non-resident and is not required to have a resident representative; and
- the Royalty Commission resolves that the technical assistance cannot be rendered by Colombian residents.

It is furthermore established that resident subsidiaries and permanent establishments of foreign companies are not entitled to any deduction on amounts paid or owed, whether directly or indirectly, to their parent companies or foreign offices as consideration for expenses, commissions, management fees, royalties and exploitation or acquisition of intangibles.

For a comprehensive description of the tax system of Colombia, see: *Corporate taxation in Latin America*, Section C, Colombia.

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. See also Erratum (p. 193 of the May 1983 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

AFRICA

Senegal

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Multilevel Government: Some Consequences for Fiscal Stabilization Policy

by Charles Y. Mansfield

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Fiscal policy has often appeared burdened with difficulties of an "institutional" nature, when compared with other major instruments of stabilization policy – such as changes in the exchange rate, interest rates, and levels of money and credit.[1] Its implementation, for example, may entail a lengthy legislative process and substantial lags in administration before policies take effect. A possible additional barrier to carrying out a successful and coherent fiscal stabilization policy may be the existence of "multilevel government", that is, state, provincial, and local governments.[2] Although debate on the merits of decentralized government has been inconclusive, there is general agreement that stabilization policy should be essentially a central government function. In this vein, one authority has stated:

> There will be a strong case for giving a higher-level government responsibility for any decisions which, if they were instead to be carried out by lower-level government with restricted jurisdictions, would generate external effects in adjoining jurisdictions. It is this criterion that suggests that federal governments should have the overriding responsibility for international economic stabilization and redistribution policies.[3]

From this point of view, the existence of subnational units of government involves a potential cost in terms of the efficiency of fiscal stabilization policy. This paper will first examine some of the evidence on the growth and the importance of subnational (state, provincial, or local) units of government. The critical question of the real or imagined independence of subnational units of government will then be treated, and contrasting styles of multilevel government will be illustrated. Finally, the question of whether subnationals tend to exert a stabilizing or destabilizing impact on the economy will be treated. Throughout this paper the emphasis will be on multilevel government rather than "fiscal federalism" as such.[4]

1. Fiscal policy is defined here in the context of demand management policy, aimed at achieving full employment (output), a low rate of inflation, and equilibrium in the balance of payments.
2. While the proper role of subnational units of government has indeed become a topical subject in many countries, justification for decentralized government has generally been offered in terms of allocation arguments. As one authority has stated, "the decentralization of the public sector is of importance because it provides a mechanism through which the levels of provision of certain goods and services can be fashioned according to preferences of geographical subsets of the population" (Oates 1972: 17).
3. Mathews (1980: 8). See also Musgrave (1969).
4. "Fiscal federalism" has been defined as a system in which the central and subnational units of government are "each within a sphere, coordinate and independent", and often federal systems have a constitutional basis. This definition implies, however, that subnational units have financial autonomy and by this criterion alone would rule out not only "nonfederal" multilevel governments but also present-day federal systems. In fact, subnational units of government are often quantitatively important in countries that are not federal republics. See Bird (1980).

I. THE IMPORTANCE OF STATE AND LOCAL GOVERNMENTS: A QUANTITATIVE VIEW

If state (provincial) and local governments are to have an impact on fiscal stabilization policy, their revenues and expenditures must have some quantitative importance. As a starting point, we might ask what level of resources they are able to command. Table 1 shows the ratio of "own" revenue of state and local governments combined as a percentage of both gross domestic product (GDP) and central government revenue.[5] For convenience, the countries have been divided into three groups: "industrial federal countries", "other industrial countries", and "developing countries". (This latter group also includes some federations.)

The half dozen industrial federal countries – Canada, Switzerland, the Federal Republic of Germany, the United States, Austria, and Australia – have a mean ratio of 14.2% of own revenues to GDP, ranging from 8.3 for Australia to 19.3 for Canada. State and local revenue in these federations averages 64% of central government revenue, ranging from 32% in Australia to over 100% in Canada. These ratios imply a potentially significant impact on fiscal policy, since state and local revenues clearly constitute a sizable proportion of GDP and total government revenues. The group of other industrial countries shows a wide variation in the combined total of state and local government revenue to GDP. (Among these countries, only Yugoslavia has "states" or provinces as a functioning fiscal unit.) Local entities are important in the Scandinavian countries (Denmark, 14.5; Norway, 16.9; Sweden, 18.0; Finland, 10.1). A "medium" group of countries in this class, with still significant local revenues to GDP, includes the United Kingdom (6.4), Ireland (4.6), Romania (5.8), and Yugoslavia (6.2). Some of the other industrial countries have lower ratios, including Italy (1.3), Luxembourg (3.5), the Netherlands (2.1), Greece (0.9), Portugal (0.9), and Spain (1.3). Industrial countries outside the traditional federal republics thus run a wide gamut between local governments with a potentially powerful fiscal impact and those of very marginal influence.

For the 22 developing countries for which these data are available, Brazil, Ecuador, India, Korea, Malaysia, and Pakistan include data on state units, although the fiscal independence of the states is generally much less significant than in the industrial federal countries.[6] These "federal" developing countries have much higher own revenue ratios to GDP (ranging to more than 7%) when compared with other developing countries with only local governments. Subnational revenues in the federal developing countries are high enough to have a potentially significant fiscal impact but are still lower than most industrial federal countries and lower than the ratios of many of the other industrial countries. Local government units in developing countries outside the "federal" class have generally very low ratios of own revenue to GDP.

Since central, state, and local governments each collect revenues and carry out expenditures, any combination of surpluses, deficits, and transfers among them would in theory be possible. However, multilevel governments throughout the world show a remarkable similarity in that a one-way flow of resources takes place from the upper level of government to the lower. This flow of resources from the central government may take a variety of forms, but its basic function from the stabilization point of view is to finance the gap between the "own" revenues and "own" expenditures of lower-level governments. Flows from the central government may typically go to both state and local governments, and, in addition, a flow of resources from the state to the local government often takes place. A variety of particular reasons could be given for each country for the one-way flow from the central government, but a general explanation is that central governments have tended to capture major, elastic sources of revenue, while expenditures have typically been shifted to state or local levels, which are perceived as better able to spend efficiently.

These one-way financial flows from the central government are shown in Table 2. Among the federal industrial countries, the ratios to GDP are generally not high, demonstrating the relative strength of the tax systems of the subnational governments. The United States, the Federal Republic of Germany, and Switzerland have ratios of 3% or below. Australia has a higher ratio (6.4), which in turn reflects its relatively lower state and local tax ratio as compared with other industrial federal countries. Many industrial countries without federal systems have higher transfers than countries with federal systems. Countries with large transfers to local governments include Denmark (14.2), the Netherlands (13.7), Japan (6.7), Ireland (8.0), Sweden (5.8), Norway (5.2), and Italy (5.1). Among developing countries, as shown in Table 2, the transfer ratios of central government to other levels of government are, with a few exceptions, much lower, reflecting the fact that the size of subnational governments is relatively smaller and, perhaps, that transfers to state and local governments in most developing countries have a low priority in central government budgets.

Tables 3 and 4 illustrate the fact that state and local governments are chronically in deficit, even after taking into account transfers from the central government. Table 3 shows the overall balance of local governments. For federal countries, the mean ratio is minus 0.3, ranging from a deficit of 0.7 for Canada to a surplus of 0.6 for the United States. For the group of other industrial countries, the mean ratio is minus 0.9, but the range is wide, from deficits of over 2% of GPD in the United Kingdom and Ireland to small surpluses in Denmark, Portugal, and Romania. For the developing countries, the overall deficit of local governments is almost uniformly low, reflecting the fact that the local governments are small relative to the central governments and that the local governments have less access to capital markets to finance a deficit.

Table 4 shows the overall balance of state governments as a percentage of GDP. For the federal industrial countries, the ratios range from a surplus for the United States

5. "Own" revenue includes tax and non-tax revenue but excludes transfers from other levels of government.

6. Nigeria is another important federation, but data for this country are not published in the Fund's *Government Finance Statistics Yearbook*, the source of much of the data used in this paper.

Table 1
Combined revenue of state and local governments

	1975	1976	1977	1978	1979	Average for period	1975	1976	1977	1978	1979	Average for period
Industrial federal countries	*(As percent of gross domestic product)*						*(As percent of central government revenue)*					
Canada	18.30	19.01	20.12	20.47	18.82	19.34	91.5	100.5	115.0	119.6	108.3	107.0
Switzerland	16.75	17.29	15.88	17.89	17.71	17.10	93.3	87.6	80.7	89.0	90.3	88.2
Germany, Fed. Rep.	15.53	15.92	16.88	14.74	16.23	15.86	59.1	58.9	62.1	54.2	60.0	58.9
United States	13.10	13.11	12.90	12.57	12.24	12.78	65.5	68.4	63.9	62.1	58.0	63.6
Austria	12.01	11.83	11.70	12.30	11.58	11.88	38.0	37.5	36.2	35.5	33.3	36.1
Australia	7.88	8.21	8.42	8.61	8.30	8.28	31.0	31.9	32.0	32.3	32.2	31.9
Mean ratio						14.21						64.3
Other industrial countries												
Sweden	15.78	15.97	18.10	20.16	20.13	18.03	45.7	40.5	44.3	49.1	50.9	46.1
Norway	17.82	16.21	16.88	17.04	16.59	16.91	49.4	43.3	44.1	44.4	42.6	44.8
Denmark	14.53	–	–	–	–	14.53	47.4	–	–	–	–	47.4
Finland	9.69	10.15	10.59	9.95	–	10.09	34.6	32.5	34.5	34.6	–	34.0
United Kingdom	6.66	6.43	6.36	6.32	6.41	6.43	18.5	18.1	18.1	18.8	19.1	18.5
Yugoslavia	6.02	5.72	6.33	6.60	–	6.17	25.2	24.1	26.1	26.8	–	25.5
Romania	6.30	6.42	5.77	5.34	5.02	5.77	12.7	13.7	11.4	10.6	9.5	11.6
Ireland	4.89	4.18	4.72	4.00	–	4.60	14.6	13.3	13.1	11.1	–	13.0
Luxembourg	3.67	2.63	3.32	3.73	4.12	3.49	8.2	5.8	6.7	7.4	4.8	6.6
Netherlands	1.84	1.99	2.11	2.19	2.23	2.07	3.7	4.0	4.2	4.3	4.4	4.1
Spain	1.08	1.32	1.39	1.34	1.52	1.33	5.2	6.4	6.1	5.7	6.3	5.9
Italy	1.32	–	–	–	–	1.32	4.5	–	–	–	–	4.5
Greece	0.79	0.88	0.88	0.89	–	0.86	2.8	2.9	2.8	2.8	–	2.8
Portugal	0.94	0.79	–	–	–	0.86	3.7	2.9	–	–	–	3.3
Mean ratio						6.60						19.1
Developing countries												
Brazil	7.81	7.42	7.53	7.55	7.63	7.59	40.2	36.3	36.9	37.6	39.9	38.2
India	5.99	6.32	6.05	6.39	–	6.19	48.4	49.7	48.1	48.2	–	48.6
Pakistan	3.75	4.30	4.20	4.60	4.57	4.28	29.5	32.0	23.5	24.9	30.3	28.0
Malaysia	3.58	4.26	4.19	4.12	5.25	4.28	16.0	19.6	17.4	17.0	22.4	18.5
Somalia	3.30	–	–	–	–	3.30	10.6	–	–	–	–	10.6
Korea	2.64	2.73	3.95	3.20	–	3.13	17.0	15.7	22.9	17.9	–	18.4
Ecuador	2.71	2.59	2.41	2.43	2.31	2.49	22.7	23.5	23.8	24.1	23.2	23.5
Kenya	1.86	1.97	1.87	1.64	1.61	1.79	9.5	10.2	10.1	7.0	7.1	8.8
Gambia, The	1.33	–	–	–	–	1.33	7.1	–	–	–	–	7.1
Sri Lanka	1.06	1.04	0.93	–	–	1.01	6.0	5.9	5.4	–	–	5.8
Honduras	0.94	1.06	–	–	–	1.00	6.7	7.0	–	–	–	6.8
Thailand	1.01	0.97	1.00	1.00	–	0.99	7.4	7.2	6.9	6.8	–	7.1
Fiji	0.58	0.96	1.13	0.97	–	0.91	3.0	4.9	5.6	4.3	–	4.4
Panama	0.92	0.89	–	–	–	0.90	4.1	4.2	3.4	3.1	–	3.7
Costa Rica	0.60	0.84	0.79	0.79	0.76	0.76	3.5	4.9	4.8	4.2	2.8	4.0
Iran	0.70	0.70	–	–	–	0.70	1.5	1.7	–	–	–	1.6
Paraguay	0.36	0.52	0.50	0.51	0.48	0.47	3.2	4.7	4.2	4.1	4.0	4.0
Mexico	0.39	0.41	0.38	–	–	0.39	2.9	3.0	2.6	–	–	2.8
Dominican Republic	0.39	0.37	–	–	–	0.38	2.0	2.3	–	–	–	2.1
Mauritius	0.40	0.38	0.37	0.31	0.35	0.36	1.9	1.4	1.4	1.3	1.4	1.5
Venezuela	0.26	0.30	0.33	0.32	0.29	0.30	0.7	1.0	1.2	1.3	1.3	1.1
Ethiopia	0.29	0.24	0.22	–	–	0.25	2.3	1.9	1.5	–	–	1.9
Mean ratio						1.95						11.3

Source: International Monetary Fund, *Government Finance Statistics Yearbook* (1981).

to a deficit of over 1½% of GDP for Australia.[7] "Federal" developing countries vary widely. India and Pakistan show large deficits, while Brazil, with the largest percentage of state revenues to GDP among developing countries, shows state governments much closer to a balance.

This brief survey of the quantitative aspects of multilevel governments establishes two main points:

1. In industrial countries, both "federal" and "other", the level of both revenue and expenditure of subnational governments is high enough to have an impact on fiscal stabilization policy. Developing countries, in this respect, are far more "centralized". With a few important

7. More recent data, if available in a comprehensive form, would reflect the world recession, showing greater deficits, or a change from a surplus to a deficit in the United States.

Table 2
Central government transfers to other levels of government
(as percent of GDP)

	1972	*1973*	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*Average for period*
Industrial federal countries									
Australia	4.71	4.83	4.94	6.12	7.61	7.34	8.00	7.99	6.44
Canada			4.35	4.34	4.81	4.54	4.58	4.43	4.51
Austria		3.04	3.21	3.38	3.30	3.31	3.62	3.60	3.35
United States	2.33	2.69	2.40	2.64	2.79	2.82	2.82	2.64	2.64
Switzerland	1.43	1.29	1.49	1.47	1.84	1.70	1.65	1.65	1.56
Germany, Fed. Rep.	1.25	1.12	1.46	1.52	1.45	1.56	1.66	1.66	1.46
Mean ratio									3.33
Other industrial countries									
Denmark	12.75	13.61	14.63	14.85	15.30				14.23
Netherlands		10.81	12.59	13.96	14.35	14.53	14.78	14.98	13.71
Ireland	5.57	6.24	7.54	8.59	8.76	9.08	10.22		8.00
Japan	5.14	5.35	6.25	6.61	6.98	7.13	7.77	7.98	6.65
United Kingdom	5.10	5.44	5.72	7.40	7.55	6.55	6.19	5.99	6.24
Sweden	4.74	5.17	5.44	5.45	5.66	6.10	6.79	7.16	5.81
Norway	3.84	3.54	3.41	5.78	6.31	6.02	6.09	6.05	5.19
Italy		2.50	3.13	4.80	5.11	4.53	7.90	7.80	5.11
South Africa	5.10	4.75	4.78	4.86	4.67	4.36	4.28	–	4.68
Finland	3.20	3.46	3.55	4.41	5.06	5.49	5.70	5.63	4.56
New Zealand	3.52	3.60	3.98	4.21	4.10	4.48	4.92	4.88	4.21
Belgium	2.82	2.77	2.82	3.18	3.26	3.41	3.48	3.40	3.14
Luxembourg	2.54	2.37	2.44	3.19	2.89	3.13	3.08	2.88	2.81
Spain	0.93								0.93
Turkey	0.45	0.64	0.25	0.29	0.21	–	–	0.80	0.44
Mean ratio									5.71
Developing countries									
India			3.05	3.68	3.70	3.60	3.86	4.64	3.75
Korea	4.49	3.47	3.12	3.45	3.59	3.61	3.44	3.94	3.64
Sudan	1.81	4.15	4.01	3.68	3.97	3.74	3.65		3.57
Costa Rica							2.98	3.18	3.08
Tanzania	2.79	3.29	2.54	4.33	2.11				3.01
Morocco	0.63	0.83	1.13	5.68	3.45	–	4.04	4.37	2.88
Ghana	0.10	–	–	3.26	3.12	3.58	–	–	2.51
Netherlands Antilles		3.39	2.96	1.09	1.35	2.51			2.26
Brazil	2.04	1.85	2.22	2.10	1.95	2.45	2.03	2.25	2.11
Venezuela	2.55	2.07	1.93	2.85	1.78	1.53	1.41	1.95	2.01
Indonesia	1.85	1.46	1.85	1.92	1.90	2.36	2.12	1.96	1.93
Thailand	1.70	1.45	1.44	1.95	2.12	1.60	1.71	1.80	1.72
Pakistan		1.77	1.37	1.32	1.37	1.79	2.20	2.19	1.71
Zaire	1.59	1.33	1.27	1.86	1.82	0.91	1.07		1.41
Malawi	1.50	2.00	1.33	1.17	1.03	0.52	1.13	0.95	1.20
Kenya		0.61	–	1.64	1.33	1.17	1.13	1.28	1.19
Botswana	0.42	0.19	1.49	1.88	0.86	0.77	0.73	1.52	0.98
Mauritius		0.42	0.65	0.67	1.17	1.23	1.17	1.36	0.95
Oman	–	–	–	0.68	0.93	1.19	1.27	0.58	0.93
Malaysia	1.47	0.95	0.71	0.89	0.76	0.85	0.91	0.55	0.89
Guatemala	0.45	0.45	0.45	0.52	0.68	0.61	0.72		0.55
Philippines	0.43	0.66	0.65	0.57	0.52	1.11	0.35	0.05	0.54
Madagascar	0.49	0.51							0.50
Zambia	0.48	0.37	0.15	–	–	0.64	0.64	–	0.46
El Salvador				0.52	0.41	0.38			0.44
Swaziland	0.43	0.29							0.36
Uruguay	0.48	0.24	0.19	0.08	0.01	0.01	0.01		0.13
Gambia, The		0.18	0.05	0.05	0.04	0.19			0.10
Cyprus	0.12	0.14	0.26	0.05	0.05	0.07	0.05	0.04	0.10
United Arab Emirates	–	–	0.01	0.01	0.01	0.01	–	–	0.01
Mean ratio									1.50

Source: International Monetary Fund, *Government Finance Statistics Yearbook* (1981).

Table 3
Local governments: own overall balance
(as percent of GDP)

	1972	*1973*	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*Average for period*
Industrial federal countries									
United States	0.20	0.55	0.77	0.39	0.26	1.08	0.82	0.74	0.60
Switzerland	−1.07	−0.62	−0.69	−0.36	−0.11	0.22	0.35	0.25	−0.25
Australia	−0.39	−0.34	−0.41	−0.46	−0.43	−0.27	−0.36	−0.38	−0.38
Germany, Fed. Rep.	−1.19	−0.95	−0.85	−0.89	−0.35	−0.11	−0.11	−0.34	−0.60
Canada	−1.02	−0.70	−0.66	−0.93	−0.78	−0.63	−0.55	−0.25	−0.69
Mean ratio									−0.26
Other industrial countries									
Romania	0.74	0.57	0.57	0.66	0.77	0.55	0.52	0.47	0.61
Denmark	0.69	1.01	−0.39	−0.30					0.25
Portugal			−0.08	0.09	0.42				0.14
Yugoslavia	0.00	−0.01	−0.01	−0.02	−0.05	−0.11	−0.07		−0.04
Spain	−0.08	−0.27	−0.27	−0.35	−0.63	0.47	0.68		−0.06
Greece	−0.13	−0.13	−0.08	−0.08	−0.04	−0.09	−0.16		−0.10
Finland	−0.24	−0.38	−1.04	0.08	0.14	0.62	−0.10		−0.13
Luxembourg	−0.27	0.55	0.05	−1.09	−1.51	−1.01	−0.33	−1.22	−0.60
Sweden	−0.70	−0.41	−1.99	−2.07	−1.40	−1.79	−0.33	−0.66	−1.17
Norway	−1.15	−1.24	−0.84	−1.74	−1.13	−0.98	−2.06	−1.82	−1.39
Netherlands			−2.11	−2.09	−1.27	−1.17	−1.06	−0.97	−1.44
Italy		−1.26	−1.25	−3.11					−1.87
United Kingdom	−2.33	−3.43	−3.97	−2.60	−1.52	−1.04	−0.92	−1.13	−2.12
Ireland	−1.89	−2.54	−3.84	−3.70	−2.73	−1.81	−1.56		−2.58
Japan	−2.58	−2.28	−2.94						−2.60
Mean ratio									−0.87
Developing countries									
Somalia		−0.07	0.59	0.79					0.44
Mauritius			0.12	0.04	0.48	0.50	0.23	−0.03	0.22
Sri Lanka		0.19	0.10	0.13	0.18	0.17			0.15
Cyprus	0.16	0.11	0.11	0.08	0.09				0.11
Swaziland	0.10	0.43	−0.03	−0.10					0.10
Iran	0.11	0.09	0.13	0.03	0.08				0.09
Thailand	−0.02	0.08	0.17	0.07	0.17	0.09	0.05		0.09
Dominican Republic	0.03	0.14	−0.01	0.06	0.02				0.05
Korea	−0.73	0.15	0.11	0.22	0.21	0.19	0.08		0.03
Gambia, The		−0.38	0.13	0.20					−0.02
Panama		0.02	−0.04	−0.03	−0.05	−0.04	0.02		−0.02
Paraguay		−0.03	−0.03	−0.01	−0.04	−0.07	−0.06	−0.02	−0.04
Ecuador			−0.17	−0.09	0.13	−0.26	0.08	−0.01	−0.05
Ethiopia	0.00	−0.03	−0.06	0.00	−0.20	−0.09			−0.06
Kenya	−0.55	−0.13	0.06	−0.01	0.16	0.09	−0.06	−0.15	−0.07
Venezuela	−0.12	−0.10	−0.07	0.16	−0.24	0.07	0.02	0.24	−0.08
Honduras	−0.06	0.03	−0.29	0.18	−0.27				−0.08
Mexico	0.02	−0.05	−0.10	−0.13	−0.17	−0.18			−0.10
Brazil	−0.08	−0.10	−0.44	−0.18	−0.17	−0.14	−0.15	−0.03	−0.16
Costa Rica	−0.26	−0.34	−0.22	−0.22	−0.27	−0.27	−0.19	−0.16	−0.24
Bahrain				−0.40					−0.40
Sudan	−0.95	−0.86	−0.34						−0.72
Fiji			−1.04	−0.84	−1.20	−1.14	−0.53		−0.95
Bangladesh			0.02	0.00	−0.02	0.01			–
Mean ratio									−0.07

Source: International Monetary Fund, *Government Finance Statistics Yearbook* (1981).

Table 4
State governments: own overall balance
(as percent of GDP)

	1972	*1973*	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*Average for period*
Federal industrial countries									
United States	0.46	0.64	0.41	0.15	0.54	0.59	0.66	0.41	0.48
Switzerland	−0.81	−0.39	−0.42	−0.44	−0.62	−0.22	−0.14	−0.60	−0.45
Germany, Fed. Rep.	−0.17	−0.21	0.08	−0.53	−1.38	−0.67	0.96	1.05	−0.61
Canada	−0.87	−0.68	−0.76	−2.30	−1.84	−1.19	−0.53	–	−1.17
Austria		−0.93	−1.42	−1.47	−1.81	−1.50	−1.52	−1.25	−1.41
Australia	−1.68	−1.39	−1.39	−2.16	−1.42	−1.69	−1.65	−1.27	−1.58
Other industrial countries									
Yugoslavia	0.00	−0.02	−0.20	−0.15	−0.16	0.02	0.05		−0.06
Developing countries									
Netherlands Antilles			3.93	3.24	1.53	−2.97			1.43
Korea	0.17	0.46	0.20	0.27	0.31	0.33	0.26		0.28
Uruguay		0.04	0.04	0.27	0.20	0.04			0.12
Ecuador			0.16	−0.04	−0.06	0.00	−0.06	0.01	0.00
Mexico	−0.54	−0.62	−0.34	−0.36	−0.21	−0.71	−0.39		−0.45
Brazil	−0.30	−0.30	−0.39	−1.01	−1.20	−0.36	−0.90	−0.62	−0.63
Malaysia	−2.18	−0.81	−0.98	−1.98	0.20	−0.36	−0.19	0.26	−0.73
India			−1.56	−1.60	−1.73	−2.11	−2.40		−1.88
Pakistan				−2.70	−3.87	−3.08	−1.14	−2.10	−2.58

Source: International Monetary Fund, *Government Finance Statistics Yearbook* (1981).

exceptions (Brazil, Nigeria, India, and perhaps Pakistan and Malaysia), both revenues and expenditures of subnational governments are generally too small to affect fiscal stabilization policy significantly.

2. The structure of financial relationships among levels of government shows a one-way flow from central governments to subnational governments. However, this one-way flow is relatively much less important in developing countries than in industrial countries.

II. ARE SUBNATIONAL UNITS INDEPENDENT? A FRAMEWORK OF ANALYSIS

The preceding survey of aggregate quantitative data on state and local governments would imply that, in most industrial and a few developing countries, state and local governments can potentially exert some significant influence on overall stabilization policy. A fundamental question, however, is whether, or to what degree, these units of government are able to make autonomous decisions regarding their revenues and expenditures. If the structure and level of taxes and expenditures at all levels of government were in fact effectively controlled from the central government, any supposed difficulty in carrying out fiscal stabilization policy would be illusory. As one observer has warned:

> No simple measure of fiscal centralization can adequately measure how far local governments are independent of central governments. The degree of real local autonomy, in the sense of independent decision-making authority, cannot be assessed simply by considering the relative importance of local revenues or expenditures in the public sector budget as a whole.[8]

From the point of view of the impact of state and local governments on fiscal policy, the question is whether, or to what extent, subnational units of government can independently set their own aggregate levels of expenditure, revenue, and borrowing. Although the institutional relationships of multilevel government differ from country to country, it may be useful to set up a framework of analysis within which individual cases can be evaluated.[9] From the available data it is known that the typical state or local government undertakes expenditure (E), which is financed by its own tax and non-tax revenue (T_o), revenues stemming from tax sharing (T_s), and grants from the central government, which may be conditional or open-ended (G_c or G_o). In addition, the state or locality may have the ability to borrow (B). Since subnational units do not have access to the central bank[10] to finance any residual expenditure, we have the identity:

$$E = T_o + T_s + G_c + G_o + D \qquad (1)$$

To ascertain the "independence" of the subunit, we would like to know which elements of the identity can be varied at will by the subnational units and which are determined by the central government.[11] As a starting

8. Bird (1978).
9. In the following discussion, the author has drawn from Hunter (1977).
10. India provides a partial exception to this rule, as state governments have had limited access to central bank credit in recent years.
11. This discussion centers on the discretionary actions of the central government and the subunits, abstracting from the impact of the economy on levels of revenue and expenditure in the budget.

point, we can consider three types of subunits: a highly "independent" state or local government, a unit with some independence, and a completely "dependent" unit. In a completely independent unit, the local or state government could set its own level of expenditures, exercise discretionary tax policy, decide on the level of conditional grants that it would receive from the central government, borrow independently in the capital market, and finance residual expenditure by unconditional grants from the central government. In this case, we might say that the unconditional grants from the central government and net borrowing from the public represent the "overall deficit" of the state or local government. The overall deficit of this "independent" unit could be represented by

$$E - (T_o + T_s + G_c) = G_o + B \tag{2}$$

The level of expenditure of the "independent" subnational unit would be a function of its own tax rates, its tax-sharing arrangements, its ability to borrow in capital markets, and its use of conditional and open-ended grants. In fact, no real-life subnational unit of government does possess this degree of independence, and, to add a note of realism to the discussion, the level of expenditure would certainly be constrained by some limit to the conditional and open-ended grants available. In addition, the revenue-sharing process would not be completely determined by the subunit.

A second and more realistic case might involve a state or local unit which has the authority to set its own tax rates and other revenue sources, is able to borrow independently, but does not have any influence on the level of matching and unconditional grants it receives from the central government or on tax-sharing arrangements. In this case, the residual financing of the lower-level unit might be represented by the tax-shared revenues, grants, and borrowing:

$$E - T_o = T_s + G_c + G_o + B \tag{3}$$

A third and limiting case would be that in which the state or locality has no authority to set tax and non-tax revenues, has no influence over the level of grants it receives, and is not able to borrow independently. In this case, its expenditures would then effectively also be set by the central government, and no problem of harmonizing policy would arise.

1. A coefficient of independence

These three ideal types could be generalized by recognizing the fact that there is a continuous spectrum between complete dependence and complete independence of a subnational unit. The expenditure of a state or local unit may depend on "own" receipts that are, to varying degrees, within its control, such as its own tax and non-tax revenues, and receipts that depend partly or wholly on the central government, including tax-sharing arrangements and conditional and open-ended grants. Since the "independence" of a subnational unit depends on its ability to command resources, we may focus on the receipt side of the balance. In fact, many receipt sources would not be completely controlled by either the central government or the subunit but would be a matter of bargaining between the two. Ideally, we could give a weight to each source of state or local revenue ($0 \leq a_i \leq 1$) so that

a_1R_1 represents the proportion of own tax and non-tax revenues (T_o) that can be controlled by a subnational government;

a_2R_2 represents the proportion of tax-sharing revenues (T_s) that can be controlled by a subnational government;

a_3R_3 represents the extent to which conditional grants (G_c) can be controlled by a subnational government;

a_4R_4 represents the extent to which open-ended grants (G_o) can be controlled by a subnational government;

a_5R_5 represents the extent to which borrowing (B) can be controlled by a subnational government.

Then, a "coefficient of independence" (V) has been defined as follows:[12]

$$V = \frac{\Sigma\, a_iR_i}{\Sigma\, R_i}\text{, where } 0 \leq V \leq 1 \tag{4}$$

It is clear that (V) can have a range of values from zero to unity. At one extreme, own tax and non-tax revenues would be non-existent or entirely controlled by the central government, and tax-sharing and grant arrangements would be at the discretion of the central government. At the other extreme, all subnational expenditure would be covered by revenue sources under its own control. In practice, multilevel government relations tend to fall into patterns based on historical and institutional precedents.

2. Three types of multilevel government

As noted above, the coefficient of independence, V, varies widely among countries and could change over time in the same country as the institutional framework varied. In general, V would appear to be small in most, although not all, developing countries where the level of own revenues and grants is effectively controlled from the central government. Among other multilevel governments, three distinct types might be identified – one with an emphasis on own revenue, one depending most heavily on revenue sharing, and a third depending on grants from the central government.

A first type of multilevel government might be labeled "classical federalism", embodying the idea that each level of government should have its own resources and thus its own "financial integrity". Consistent with this line of thought, lower levels of government would not be subject to an undue influence from the central government that stemmed from financial dependence. This type of multilevel government would place emphasis on the ability of the subnational unit to raise its own tax and non-tax revenues. In terms of our definitional equations, each subunit would run a balanced budget, in which expenditure was financed by own revenue and the overall deficit was represented by own borrowing of the subunit.

$$E - T_o = B \tag{5}$$

If grants were introduced into the system, it might be assumed that they were ageed upon by bargaining between the subunits and the central government, and would be

12. See Hunter (1977).

reflected in an equal increase in expenditures. Thus, the overall deficit (B) would not change:

$$E - T_o - G_c = B \tag{6}$$

A second type of multilevel government can be labeled "cooperative federalism" and would depend mainly on revenue sharing. Revenue sharing in the broad sense would imply any sharing of general revenues with subnational units, although most revenue-sharing plans envision earmarking a specific proportion of a tax to a particular level of government. Under this ideal type, the budget of the subunit would be balanced, with the exception of any independent borrowing allowed:

$$E - T_s = B \tag{7}$$

The third type of multilevel government is labeled "dependent local government" and is characterized by a high level of local expenditure financed in large part by grants from the central government, usually with some element of own revenue of the subunit. Grants from the central government may stem from constitutional requirements or habitual agreement, and thus be fixed in amount. In other cases, grants may be available to finance additional spending. In such cases, the subunit does not have a balanced budget, and the overall deficit may represent a residual that could be varied by stabilization policy:

$$E - T_o = G_o \tag{8}$$

Although no multilevel government may exactly fit one of these types, they represent a useful device for clarifying the impact of different institutional arrangements on stabilization policy. "Classical federalism" represents the original vision of a federal republic such as the United States and the present-day federal republic of Switzerland. The United States, however, has moved toward a system that relies on substantial grants from the central government, and has since the early 1970s begun to experiment with limited forms of revenue sharing. A more clear-cut example is the Federal Republic of Germany, which corresponds closely to the cooperative federalism or revenue-sharing model. Among developing countries, Nigeria also corresponds closely to this model. Examples of the third type, local expenditure financed largely by central government grants, would include a number of industrial non-federal countries, particularly the Scandinavian countries. These real-life embodiments of the three types of multilevel government will be examined in the following subsections.

a. "Classical federalism": the United States

Federalism in the United States embodies the concept of financial autonomy for subnational units. Under the Constitution, each state is given the right to any tax source, except that states are not allowed to tax foreign trade. In theory, this system would allow for a federalist model in which each state is able to raise its own revenues to finance the amount of expenditures it wishes to make. In practice, the Federal Government has in modern times pre-empted major tax sources – the personal and corporate income tax – leaving the states to rely on sales taxes and "piggyback" income taxes, while localities rely heavily on property taxes. Thus, each level of government has tended to "specialize" in particular taxes rather than to share major revenue sources. In addition, following the depression of the 1930s, states and localities in the United States have been in part dependent on government grants, and the share of state-local expenditure financed by government grants (federal aid) has increased dramatically since World War II.

While the state-local sector was one of the most rapidly growing parts of the national economy in the 1960s and early 1970s, this growth slowed in the latter part of the 1970s, and the growth that occurred in that period was primarily the result of increases in federal aid. After 1977, however, both the state-local sector and federal aid to states and localities declined slowly as a percentage of gross national product (GNP). Federal aid as a percentage of state and local government own general revenue rose from 11.8% in 1955 to 31.7% in 1978. Following this peak, federal aid dropped to 24% of own state-local receipts in 1982.[13] The third major form of financing – revenue sharing – has been introduced so far only in a marginal form. Beginning in the 1970s, specific amounts of general revenue have been assigned to states and localities over a specific number of years. Proposals of the "new federalism" in the United States would shift the balance toward more reliance on "own revenue" by reducing federal aid, and presumably forcing subnational units to make decisions on raising taxes. It is interesting to note that recent proposals of the new federalism would also mark a further step toward revenue sharing in the form of the creation of a trust fund financed from federal excise taxes. Each state would receive a trust fund allocation based on its share of the programs being turned back to the states. The federal excises supporting the trust fund would, under the proposal, be gradually eliminated.

Given the historical change from a more autonomous state and local government sector to somewhat greater dependence on federal aid, we may ask the question: Has state and local government been procyclical or anticyclical in the United States? A recent study examines this question for each cyclical swing in the period 1957 through 1977.[14] Several measures of stabilizing behavior are used. First of all, average quarterly rates of change of state and local expenditures, receipts, and surpluses were calculated for each period of recession and expansion. For each of the four recessions, expenditures grew more rapidly than receipts and a deficit was registered. Correspondingly, in each of the expansionary periods receipts grew more rapidly than expenditures and a surplus was registered.[15] By this rough evidence, the behavior of state and local government could be said to be countercyclical. A more sophisticated measure of "fiscal leverage" was then used to estimate the impact of state and local government. The leverage measure used different weights for expenditure, taxes, and transfers and allowed for time lags between the initial fiscal impact and subsequent effects was well as inflation adjustment factors. The fiscal leverage estimates indicate that state and local governments added to real GNP in recessionary periods. In expansionary periods, the trend was also toward countercyclical behavior in the sense that the net

13. See U.S. Advisory Commission on Intergovernmental Relations (1981).
14. U.S. Advisory Commission on Intergovernmental Relations (1979).
15. Ibid., pp. 6–7.

expansionary impact was much lower than in recessionary periods. (Note that this was a period of secular increase in state and local expenditure.) For the last expansionary period studied, 1975–77, the expansion was actually slowed down by state and local government behavior.

What were the reasons for the generally stabilizing role of state and local governments in this period? First of all, it should be noted that the measures quoted above do not differentiate between discretionary and automatic effects. In general, it appears that discretionary effects played a small role.[16] Two factors are said to explain the stabilizing behavior. The most important follows from the fact that state and local governments are expected to have balanced budgets.

> Since these governments must at least plan a balanced budget, their tendency is to estimate revenues conservatively. If the economy is booming these conservative estimates may understate actual collections and result in unplanned surpluses. During a recession it appears that state and local governments draw down these surpluses, enabling them to maintain or increase expenditures.[17]

A second factor relates to the behavior of state and local governments during recessions. State and local governments operate on either one-year or two-year budgets, and expenditures are planned based on estimated revenue. If revenues fall short there is a time lag before expenditure adjustments can be made, and most of the recessions since World War II have not lasted long enough for state and local governments to cut expenditures.

These findings for recent state and local government behavior in the United States are contrary to earlier ideas that state and local fiscal behavior would tend to be procyclical. According to the earlier hypothesis state and local governments would raise taxes and reduce expenditures during periods of recession and follow the opposite course in expansionary phases. The "perversity" hypothesis may be traced to the classic study by Hansen and Perloff of state-local fiscal behavior during the 1930s. Hansen and Perloff summarized their findings as follows:

> The taxing, borrowing, and spending activities of state and local governments collectively have typically run counter to an economically sound fiscal policy. These governmental units have usually followed the swings of the business cycle . . . spending and building in prosperity periods and contracting their activities during depression. In the boom of the late 1920s, they added to the disposable income of the community, and bid up prices and building costs in large-scale construction activities. In the depressed 1930s, the fiscal policies of the government exerted a deflationary rather than an expansionary effect on the economy: expenditures . . . were severely reduced, borrowing was restricted, and taxes weighing on consumption were substantially increased.[18]

In general, studies of state and local fiscal behavior during the depression of the 1930s found at least some evidence of this "perverse" behavior. Much of the discussion concerning the cyclical impact of state-local government can be clarified, however, by drawing a distinction between automatic and discretionary actions. The "perversity" hypothesis relies on such discretionary actions as raising expenditures in a boom and cutting expenditure and/or raising taxes in a downswing. More recent explanations of anticyclical behavior tend to rely on institutional mechanisms (such as estimating revenues conservatively) in combination with automatic effects (e.g. raising revenue in a boom). Thus, empirical experience in the United States does not point to any inherent result with respect to the stabilization impact of state and local government. Instead, the outcome has depended on the relative weight of discretionary actions, automatic effects, and institutional procedures. As the "new federalism" changes this mix and introduces new institutional procedures (e.g. lower grants), perhaps followed by discretionary actions on the part of state and local governments, the stabilization impact of state and local governments may indeed change.

b. "Cooperative federalism"

(1) *The Federal Republic of Germany*

The Federal Republic of Germany provides an interesting contrast to what might be termed the "classical federalism" of the United States. While in the United States each state may compete with the Federal Government for tax sources, the German tax system is oriented heavily toward revenue sharing: the relative importance of shared taxes has risen steadily since World War II and amounted to about 80% of total tax revenue in 1980. The Federal Constitution provides that important revenue sources are shared jointly among federal, state (Bundesland) and, in some cases, local governments. Income taxes are shared equally by the Federal Government and the states after the local government share has been deducted. The value-added tax has also been shared since 1969, at which time the states' share of income taxes was reduced. Most of the excise taxes (e.g. oil, tobacco, alcohol) are allocated exclusively to the Federal Government. Taxes allocated exclusively to the states include the property and inheritance taxes (which are of minor revenue importance) and the automobile tax. Since 1980, the only major taxes allocated to local governments are real estate taxes. The power to decide on taxes rests predominantly with the Federal Government; however, changes in revenue-sharing arrangements require the consent of the states. In summary, the financing of state and local governments relies heavily on shared taxes from major revenue sources, although each level of government has some taxes under its own control. Tax uniformity is stressed, in the sense that an attempt is made to ensure that a taxpayer in any given state has the same tax burden.

The evolution of the German federal system provides an interesting example of an attempt to adapt a revenue-sharing system to stabilization objectives. The Stabilization Act of 1967, together with the Budget and Accounting Act of 1969, introduced changes designed to promote an anticyclical fiscal policy. Prior to 1967 the "business tax" (largely profits tax) provided an important source of local government revenue. This tax exhibited a distinctly procyclical revenue pattern, which was thought in turn to encourage procyclical investment behavior by local governments. (Local governments carry out a large proportion of public investment in the Federal Republic of Ger-

16. Ibid., p. 11.
17. Ibid., p. 12.
18. Ibid., p. 39.

many.) By the restructuring of taxes, the role of the business tax as an "exclusive revenue source" of local governments was reduced. To replace this tax, local governments were granted a share in the revenue of the income tax. The constitution was also amended at this time to authorize the Federal Government to give financial aid to the states and, via the states, to the municipalities. This aid was intended for investment purposes in periods of recession, when local governments have lower tax revenues and would have to cut back investment programs, with perverse cyclical effects.[19] Tax policy was also adjusted so as to become more flexible under the Stabilization Law. The law provided that the Federal government, by statutory decree, could raise or lower the personal income and corporate income tax by 10% for a period of one year. Another stabilization device was the creation of anticyclical reserve funds. Under the Budget and Accounting Act of 1969, the Federal Government could direct by statutory decree that federal institutions and the states channel funds in specific amounts to anticyclical reserve funds whenever necessary "to combat a disturbance of overall economic equilibrium".[20]

Judgments on the impact of the Stabilization Law and related measures have been mixed. In qualitative terms, observers have pointed out a dilemma in adapting a revenue-sharing system to stabilization goals. If the central government can change tax rates by itself, "a substantial erosion of the powers of the lower levels of government is implied".[21] If, on the other hand, such a tax change requires direct or indirect approval by the states, as in the Federal Republic of Germany, the decision-making process can be protracted and tax changes may take place only after long time lags. Looking at the overall quantitative performance of state and local governments, however, the results indicate that the reforms may have been successful. Although no data are available on the impact of state and local balances on GNP, available data permit us to consider a narrower question: Has the overall impact of state and local governments been consistent with central government policy? Table 5 shows the annual "fiscal impulse" transmitted, respectively, by the central government and by the general government to the rest of the economy. In approximate terms, state and local governments represent the difference between the concepts of central and general government, so that a comparison of the two sets of impulses shows whether state and local governments have been consistent with central government policy.[22] From the fiscal impulse data for 1973–82 in Table 5, several conclusions emerge. First, the size of the yearly fiscal impulse transmitted by state and local governments is typically larger than the impulse transmitted by the central government. The quantitative data thus bear out the importance of lower-level government in the Federal Republic of Germany with respect to stabilization policy. A second conclusion is that in all but two years the direction of the state and local impulse (positive or negative) was the same as the direction of the central government. State and local governments thus tended to follow the impact transmitted from the central government, rather than dampening or offsetting this impact.

(2) *Nigeria*

Nigeria is an important example of revenue sharing or cooperative federalism in the context of a developing country. The constitution grants exclusive authority to the states for raising revenues from explicitly defined sources; it also specifies that a portion of the revenue collected by the Federal Government is to be transferred to the states, and sets forth the criteria by which revenues so transferred are to be distributed. In general, statutory transfers from the Federal Government based on revenue-sharing agreements account for the bulk of state receipts. State expenditures generally exceed receipts, and the difference is mainly financed by loans and treasury advances from the Federal Government.

Frequent changes of the revenue-sharing formula with regard to both levels of government and distribution among states show one of the difficulties of this approach. In particular, the question of how to decide the distribution among individual states of the overall pool of revenue assigned to the states has been a thorny one. Following several earlier versions, the 1979/80 budget introduced a revenue-sharing formula by which 30% of all federally collected revenues would be allocated to the states and 10% to local governments. This formulation was amended in 1981 and again in 1982 by an arrangement under which all revenue collected by the Federal Government is paid into a Federation Account.[23] The Federation Account is distributed in the proportions of 55% to the Federal Government, 35% to state governments, and 10% to local government councils. Apart from the revenue-sharing allocations, the states receive substantial amounts from the Federal Government in the form of grants, on-lending of domestic development loan stocks, and on-lending of external project loans. Whereas the revenue-sharing receipts are determined by formula, the Federal Government decides each year how much the states are to receive as grants and the amount of development stock that will be issued. In theory, the state governments are permitted to borrow directly in the domestic capital market, but they would be unable to raise significant amounts without a federal guarantee. Instead of providing such a guarantee, the Federal Gov-

19. Neumark (1972: 231).
20. Ibid., pp. 233–35.
21. Nowotny (1982).
22. The technical concept of the "fiscal impulse" has been explained as follows: This concept begins with a distinction between changes in government receipts and expenditures associated with cyclical fluctuations in an economy and other changes, which may be viewed as imparting expansionary or contractionary impulses to the economy independently of the more or less automatic responsiveness of government transactions to cyclical developments. Revenue is regarded as cyclically neutral when it grows in proportion to actual (nominal) GNP, while expenditure is regarded as cyclically neutral if it parallels the movement of potential output at current prices (i.e. the hypothetical value of GNP under conditions of reasonably full utilization of resources). Comparison of actual fiscal balances with estimates of the hypothetically cyclically neutral balances yields a residual balance from which purely cyclical influences (according to the criteria indicated) have been eliminated. Changes in these residual balances are defined as the fiscal impulse and may be interpreted as cyclically adjusted indicators of stimulative or restrictive shifts in government operations (see International Monetary Fund 1982: 102).
23. Excepted are proceeds from the personal income tax on personnel of the armed forces, the Nigerian Police Force, the Ministry of External Affairs, and the residents of the Federal Capital Territory. Also excluded from the Federation Account are receipts from repayment of loans, interest on loans raised by the Federal Government on behalf of third parties, reimbursement of cost of particular services provided for other agencies or governments on prior agreement of refund, and sale of capital assets.

Table 5
Federal Republic of Germany: "Fiscal impulses" of central and general government

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Central government[a] Net impulse	−0.3	0.6	1.9	−0.2	−0.5	0.2	0.2	−0.3	0.1	−1.1
General government[a] Net impulse	−1.0	1.5	2.6	−1.2	−1.1	0.6	1.0	0.2	−0.1	−1.8
State and local[b] Net impulse	−0.7	0.9	0.7	−1.0	−0.6	0.4	0.8	0.5	−0.2	−0.7

Source: World Economic Outlook: A Survey by the Staff of the International Monetary Fund (April 1982), p. 189.

a. Central government accounts include social security and are on the same basis as the Fund's *Government Finance Statistics Yearbook (GFSY)*. General government accounts include additional social security in which such programs are attached to state and local governments. General government accounts are on a national income basis, that is, lending programs of government are "below the line" as contrasted with the *GFSY* treatment. However, in Germany such lending is very small compared with government expenditure.
b. Represents difference between figures for central and general government.

ernment issues development loan stocks itself, and passes the proceeds on to the states. External borrowing is generally the prerogative of the Federal Government, although in certain circumstances states can undertake such borrowing on their own. Apart from the sizable revenue-sharing receipts from the Federal Government, the states have limited revenue sources of their own. These include most importantly the personal income tax, as well as various fees and licenses, taxes on earnings from sales, and taxes on interest and dividends. Local authorities are assigned a share in the proceeds of some taxes levied at the state level, and also receive grants from the state governments. In addition, they receive the proceeds of taxes and other charges levied at the local level.

Although discussion of revenue sharing in Nigeria has focused on distributional issues – how much particular states receive from the central pool of revenue – the stabilization consequences of revenue sharing are very pertinent. Budgets of states for recent years are shown in Table 6. These data point up the difficulties with revenue sharing from a stabilization point of view. Revenues distributed to the states, although not legally required to be spent, tend to be spent in their entirety. The scope for stabilization policy through a reduction in government expenditure is then greatly reduced. In effect, a significant portion of revenues will be spent rather than retained as a surplus even when fiscal constraint is called for. In the years shown in Table 6, the states ran large budgetary deficits, comparable in size to those of the Federal Government, when a policy of restraint in aggregate demand was needed. The largest source of financing of the state deficits was loans and treasury advances from the Federal Government. Thus, the combination of large receipts from revenue sharing, which were in effect earmarked for expenditure, and central government financing of a significant portion of the states' deficits greatly complicated the task of fiscal stabilization.

24. A policy of greater alterations in the grant percentage of local current expenditure for purposes of macroeconomic policy is advocated in Foster, Jackson, and Perlman (1980: 379).

Table 6
Nigeria: Summary of the budgets of state governments, 1978/79 – 1980/81
(in millions of naira)

	1978/79	1979/80	1980/81[a] (nine months)
Recurrent revenue and grants	2,720	3,482	4,139
Of which:			
share of federally collected revenue[b]	(1,787)	(2,534)	(2,820)
federal non-statutory transfers[b]	(685)	(593)	(446)
Current expenditure	2,307	2,538	2,891
Capital expenditure	2,469	1,775	3,443
Overall deficit (−)	−2,056	−831	−2,195

Source: Budget estimates of the Nigerian authorities.

a. Covers the budget of 18 out of the 19 states.
b. Based on federal government budget estimates.

c. Dependent local governments: The United Kingdom and Scandinavian countries

Another type of multilevel government is that found in industrial countries with relatively large local government sectors. As noted earlier, the Scandinavian countries have high ratios of local revenue to GDP while the United Kingdom and Japan would fall in a middle range. Local governments in these countries also receive sizable grants from central governments. Taking data from recent years, grants amounted to more than one half of local government receipts in Denmark, 27–28% in Norway and Sweden, and a large proportion of local government receipts in the United Kingdom. The substantial grant element for these countries could in principle be used by the central government as a stabilization tool, but this does not seem to have been done in any systematic fashion.

Institutional arrangements among these countries vary. In the United Kingdom, local governments raise rev-

Table 7
Sweden: Economic effects of public sector operations
(changes in percent of previous year's GDP at constant prices)

	1973	1974	1975	1976	1977	1978	1979	1980
Central	0.8	1.2	0.4	1.1	2.2	3.4	2.5	−1.3
Local government	−0.1	0.5	1.1	0.4	0.2	−1.0	1.0	2.3

Source: Ministry of Economic Affairs, *The Revised National Budget* (1981).

enues by means of the rates, that is, the property tax. By agreement, the central government finances a certain proportion of local government expenditure by grants (the rates support grant). This proportion had been conventionally set at about 60%. Local governments can act autonomously in raising the rates to finance a higher level of expenditure, and in theory the central government would tend automatically to increase its share of the financing. However, under the present Government, local governments which set high levels of expenditure have had grants withheld by the central government. In this case the central government enforced its views in line with a fiscal stabilization policy focusing on reducing government expenditure. In general, however, the fixed proportion grant gives little scope for countercyclical action by the central government – that is, reducing grants when economic activity is expanding and increasing grants in a recession.[24]

In Sweden, local authorities have substantial autonomy in setting taxes, relying principally on a proportional income tax. (The local income tax represents a considerable part of total income taxation.) Local authorities are required in principle by the constitution to balance their budgets, including grants from the central government. Deficits or surpluses in a given year are to be taken into account in the year following. With regard to stabilization efforts, the central government and the local authorities have the stated aim of coordinating budgetary policies toward the goal of high and stable employment. As an example of this type of cooperation, the Government has negotiated agreements with the local authorities to the effect that local income tax rates would not be raised significantly during a certain period of time. In return, the local authorities have received the benefit of additional subsidies from the central government. The central government also exercises control over the timing of municipal building activities, which it can influence for countercyclical purposes.

From a more systematic point of view, however, the approximately constant proportion of central government grants to total receipts suggests that grants in overall terms are not used for countercyclical purposes. A method of seeing whether local government fiscal operations have been countercyclical is provided by the results of the fiscal impact model used by the Swedish Ministry of Economic Affairs. This is a disaggregated static fiscal model which takes into account the impact on the economy of different expenditure items and of different types of public consumption, investment, transfers, and taxes. The estimated impact is measured in terms of the net resultant change in real GDP. Data for the years 1973–80 show little correlation between the impact of the central government and that of local authorities (Table 7). The results of this impact measure with respect to stabilization policy are not conclusive, since we do not know whether central government policy was correctly designed from a stabilization point of view. However, the lack of relationship between central and local government impacts suggests that local government did not play a consistently stabilizing role.

III. STABILIZATION CONSEQUENCES OF MODELS OF MULTILEVEL GOVERNMENT

Three idealized models of multilevel government have been identified above: "classical federalism", under which subunits are given free access to their own tax sources and are expected to be financially self-supporting; "cooperative federalism", under which major tax sources are shared between the central government and the subunits; and the "grant" style of multilevel government, under which expenditures carried out by local units are substantially supported by grants from the central government as opposed to "own revenues". Although no one type is found in its pure form in any one country, the original model of the United States represented classical federalism, the Federal Republic of Germany and Nigeria are examples of cooperative federalism, and the Scandinavian countries and the United Kingdom could be considered examples in which grants have traditionally played a large role in financing local government expenditure.

From a stabilization point of view, the consequences of the three idealized types of multilevel government tend to be quite different. They may be outlined as follows:

1. "Classical federalism" gives to each state or locality a large degree of control over discretionary tax policy, one of the major instruments of stabilization policy, with allocational and distributional effects as well as the stabilization consequences that concern us. From a stabilization point of view, one can easily envision situations in which states and localities would want to carry out tax policy contrary to the central government. In the United States, for example, tax cuts by the central government may be offset by tax increases at a state and local level. In addition, tax conflict from a stabilization point of view is built into the U.S. system, since tax payments to state and local governments may be offset against federal tax

liabilities, thus tending to dampen the stabilization consequences of a federal tax change. The ability to make discretionary changes in expenditure may similarly be used to offset expenditure policies of the central government. Balanced against the potential conflict in stabilization instruments between federal and state and local governments is the fact that state and local governments generally do not have access to central bank credit. This constraint should in theory dampen any stabilization impact stemming from the state and local level. However, state and local governments can and do run cash surpluses in particular years, and can draw down these surpluses in other years. This element of flexibility could be coordinated with stabilization policy objectives.

In sum, the classical federalism model allows contrasting results with regard to stabilization policy, depending on whether discretionary or automatic effects are stressed. If state and local governments make full use of discretionary tax and expenditure policies, they can act "perversely" by raising taxes in a downswing and borrowing and spending in a boom. (This was said to be the experience of the United States in the 1920s and 1930s.) On the other hand, state and local governments may act in a procyclical fashion by allowing revenues to increase automatically in a boom and decrease in a recession, without making extensive use of discretionary powers. (This was generally true for the United States in the post-World War II period.) Such a policy relies on the automatic response of revenue and a steady or anticyclical expenditure policy to balance state and local budgets over a cycle.

2. In "cooperative federalism", based on revenue sharing of major taxes, a new set of potential stabilization problems emerges. Cooperative federalism avoids the problem of the "tax jungle", by which competing tax policies may offset central government tax policies undertaken for stabilization purposes. However, a fundamental objection to revenue sharing from a stabilization point of view is that it reduces the flexibility of overall budgetary policy. If shares of revenue are distributed to states or localities, it can be assumed that they will be spent in their entirety. Since part of overall receipts are in fact tied to equal expenditures, the scope for and the quantitative impact of discretionary fiscal policy is reduced. This problem has emerged in Nigeria, where spending by the states has complicated the task of demand management. In the Federal Republic of Germany, the rigidities of the revenue-sharing system have been amended by provisions that allow the central government to change the tax rate and to direct state revenue to reserve funds. In this way the direct link between receipt of revenue and spending is broken.

3. The model of multilevel government in which local governments make large expenditures, collect small "own revenues", and rely in large part on grants from the central government has been denigrated by critics, who are often concerned with the financial integrity and autonomy of the subunits. From a stabilization point of view, however, this model of multilevel government is theoretically more attractive than the other two. If grants from the central government constitute the overall deficit of the subunit, this overall deficit could be increased in a recession and reduced in boom periods to act as a countercyclical force. In fact, however, central governments have not consistently used grants in a stabilizing manner. In the United States, central government grants grew as a proportion of state and local expenditures from after World War II through 1978, but the trend was almost continuously upward, with little cyclical variation. Grants were used to fulfill program objectives rather than as a stabilizing tool. In other countries in which grants are a more important element of local expenditure (e.g. the United Kingdom and the Scandinavian countries), grants have tended to finance a constant proportion of local expenditure rather than play a deliberately stabilizing role. Thus, the theoretical attraction of central government grants as instruments of stabilization policy has not generally been fulfilled in practice. What are the reasons for this failure? On the one hand, apart from such obvious cases as unemployment benefits, most grants do not finance inherently cyclical expenditures. Expenditures for roads, education, schools, or medical care may raise local standards of living but do not vary automatically with the business cycle. Formulas for grants that are based on such factors as population, per capita income, or matching funds available do not encourage anticyclical fluctuations in grants. To fulfill a stabilization function, grants would have to be varied deliberately, that is, used as a discretionary tool of the central government. At present, the stabilization function of grants has not been accorded a high priority by central governments.

IV. SUMMARY AND CONCLUSIONS

This paper has examined the stabilization consequences of multilevel government. An overall quantitative view of the importance of state and local governments shows that the half-dozen industrial federal countries have a mean ratio of 14.2% of own revenues to GDP for the 1975–79 period, implying a potentially significant impact on fiscal policy. The group of other industrial countries shows a wide variation but includes high ratios for the Scandinavian countries and significant ratios in such countries as the United Kingdom and Japan. Developing countries include a federal group with own revenue ratios ranging to more than 7%, but local governments in developing countries outside this group have generally low ratios of own revenue to GDP. Multilevel governments throughout the world show a one-way flow of resources from the upper-level government to the lower, financing the gap between own revenues and expenditures. Again, the size of central government transfers varies widely, with high ratios for certain non-federal industrial countries having large local government expenditures. Transfers are generally lower relative to GDP in traditional federal countries and in federal developing countries.

Having established the potential importance of state and local government, one must ask to what extent they are truly independent. To what degree can subnational units of government independently set their own aggregate levels of expenditure, revenue, and borrowing? Three types of multilevel government are identified. The first, "classical federalism", embodies the idea that each level of government should have its own resources and thus its own "financial integrity". This type of multilevel government emphasizes the ability of the subnational unit to raise its own tax and non-tax revenues. A second type of multilevel government depends mainly on revenue sharing, by which the subunit receives allocated shares of specific taxes or general revenues collected by the central government. A third type emphasizes grants from the central government in financing a large proportion of state and local expenditure. Although no country embodies any one ideal model exactly, the United States can be classified as an example of classical federalism, with a growing element of grants from the central government in the past several decades. The Federal Republic of Germany and Nigeria are examples of "cooperative federalism", and the Scandinavian countries and the United Kingdom fall under the "grant" model.

Each model of multilevel government brings its own set of stabilization problems. Classical federalism allows conflict in revenue and expenditure policies between the central and subnational governments, but the degree of conflict in stabilization policies is limited by the fact that state and local governments must balance their budgets, at least over a period of time. Empirical studies of the United States show that state and local governments have had an anticyclical impact in the post-World War II period through 1977, although in the 1930s subnational governments were probably procyclical. Revenue-sharing arrangements solve the problem of potential conflict in tax policy between the central and subnational governments, but revenue sharing reduces the scope for central government budgetary policy, since large portions of revenue are in effect earmarked for expenditure by states. In Nigeria, state spending based largely on revenue-sharing receipts has conflicted with a need for fiscal restraint in recent years. A model of multilevel government depending on significant grants from the central government holds the most promise from a stabilization point of view, as the grants could in principle be used as an anticyclical tool. Empirically, however, central government grants have not been used in this manner. The possible stabilization function of grants has been subordinated to other objectives, such as a general increase in standards of social services and physical plant, and formulas for grants have not been designed to incorporate stabilization objectives.

Given the widespread existence of multilevel government, what can be done to make fiscal stabilization policies more effective in such a setting? The answer depends in part on the type of multilevel government that has been adopted. State and local governments depending largely on own revenues should avoid discretionary tax and expenditure actions that are procyclical, and instead allow automatic changes in revenue, combined with a steady expenditure policy, to produce anticyclical variations in the overall balance. Central governments dispensing grants could give more weight to stabilization considerations, seeking by deliberate action to raise or lower grants in a recession or a boom. (It should be recognized, however, that grants for many expenditure items, such as road maintenance or medical services, are inherently non-cyclical.) Finally, countries depending on revenue sharing should consider methods of blocking the direct link between distribution of revenues and spending by states and localities. Such methods could include, for example, the establishment of a reserve fund into which states and localities could make payments in boom periods and draw down balances in a recession. This type of device would give greater flexibility in adjusting the overall general government balance to requirements of demand management policy.

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REPORT ON THE XIth LATIN AMERICAN TAX LAW MEETING

From 15 to 20 May 1983 ILADT (Instituto Latino Americano de Derecho Tributario) held in Rio de Janeiro, Brazil, its XI Jornadas Latino Americanas de Direito Tributario, hosted by ABDF (Associação Brasileira de Direito Financeiro), IFA's Brazilian Branch, under the presidency of Dr. Gilberto de Ulhôa Canto.

The event assembled more than 250 tax experts from 10 Latin American countries, plus Portugal and Spain. The opening ceremoney was presided over by Justice João Baptista Cordeiro Guerra, President of the Brazilian Supreme Court.

Prof. J. van Hoorn Jr., chief executive of the International Bureau of Fiscal Documentation, delivered a lecture on "International Taxation".

The "Jornadas" debated two themes:
I - Income tax
General reporter: Prof. Alcides Jorge Costa (Brazil)
II - Taxation of agriculture and cattle breeding
General reporters: Prof. C.A. Mersan and Prof. O.A. Mersan Galli (Paraguay)

A panel on economic, corporative and social contributions was led by Prof. Silvio Santos Faria (Brazil).

IFA NEWS

JOINT MEETING OF SWISS AND NETHERLANDS IFA BRANCHES

On 28 and 29 April, a joint meeting of the Swiss and Netherlands IFA branches was held in Lucerne, Switzerland. Some 100 members attended the meeting of which approximately 45 came from the Netherlands.

On the first day, recent developments and problems with reference to taxation of companies were discussed mainly from the national point of view. For the Netherlands, they were highlighted by Mr. J. Hoogendoorn, and for Switzerland, by Dr. B. Ueberwasser.

On the second day, the position of international operating companies was discussed. Mr. R.H. Boon focused on the tax problems, but also discussed the advantageous tax possibilities of such companies if based in the Netherlands; the Swiss aspects of this subject as well as the possible "vehicles" for operating in Switzerland were discussed by Dr. W. Meier.

Finally, recent trends in international tax law were discussed. The speaker for the Netherlands, Mr. K. Kooijman, focused in depth on the various versions of the anti-treaty-abuse provision of Art. 16 of the U.S. Model Draft Convention which the U.S. is intending to implement in all new or renegotiated treaties and that certainly will have a fundamental effect on the position of the Netherlands and Switzerland in the future (published in the May 1983 issue of the *Bulletin*). Dr. Th. Faist (Switzerland) gave a more general overview of the policy which the Netherlands and Switzerland follow in their double taxation treaties and then discussed the Swiss anti-abuse provision and the Swiss attitude towards mutual assistance in cases of abuse of fraud in practice.

Various subjects which were covered will be discussed in forthcoming issues of the Bulletin.

BRITISH BRANCH

Report by the Chairman to the Members for the year to 31 March 1983 presented at the Annual General Meeting on Thursday, 26 May 1983.

Membership

The number of members as at 31 March 1983 was 482 made up of 379 individuals and 103 corporate members. 36 New members joined during the year while 40 left.

Branch meetings

Eight discussion meetings and a wine tasting were held by the branch during the year. The two meetings on the Revenue proposals on Taxation of International Business attracted record attendances of over 120. One meeting was followed by an informal dinner, which was a successful innovation.

Manchester Sub-Branch

Membership of the Sub-Branch is now 67. During 1982/83 five technical meetings were held at which attendance averaged approximately 35 members.

Annual dinner

The 1983 Dinner was held on on Friday, 6th May 1983 in the Naval & Military Club. The Guest of Honour was Mr. John Wakeham, Minister of State, Treasury.

Annual Congress 1982 – Montreal

The 1982 Congress was held in Montreal in September 1982 and the subjects discussed were as follows:

(1) The tax treatment of interest in international economic transactions (British national reporter: Mr. E.J. Henbrey);
(2) The taxation of payments to non-residents for independent personal services (British national reporter: Mr. J.F. Staddon).

The Congress was well supported by British Branch members.

London Congress

Arrangements for the Congress are proceeding well with the Barbican Centre booked for 8th to 13th September 1985. The British branch, as host, have engaged Conference Associates Limited to undertake the considerable administrative work involved in consultation with a working party comprising Messrs. Davidson, Hickman, Phillips, Reynolds and Roe. The Duke of Edinburgh has agreed to be Patron, and the Government is to host a Reception at the British Museum on the Monday evening. Provisionally the subjects are to be "Problems concerning the assessment and collection of tax from non-residents" and "International double taxation of estates, inheritances and gifts" with seminars on "International tax problems of tax-exempt organisations and funds" and "Tax aspects of international financial markets".

IFA Executive Committee

The Chairman has been appointed a member of the Executive Committee of Central IFA.

SWISS BRANCH

The Swiss Branch announced that its 33th ordinary meeting will be held on 17 June 1983 in Zürich. The meeting will, among other things, appoint persons representing the Swiss Branch with the General Assembly of IFA. The meeting will further discuss the subjects to be dealt with during the London Congress of IFA in 1985. Finally, a study committee on the reform of turnover tax will present its final report.

Introduction of an Inflation-adjusted Tax Base in Israel

by J.F. Pick

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The necessity of an inflation-adjusted tax base under hyperinflation

Though the average annual rate of inflation in Israel in the 4 years 1979-1982 as measured by the consumer goods price index amounted to almost 120%, the taxation of incomes in Israel has been based on accounts prepared according to historical cost until the enactment in August 1982 of an amendment[1] which provides for an inflation-adjusted tax base (in the following, "inflation amendment" or the "new law").

There has been inflation adjustment in the taxation of capital gains in Israel since the tax reform of 1975; since 1977 there has also been an option for a dollar-adjusted tax base for a specified small group of industrial enterprises with foreign participation (Amendment 15 to the Law for the Encouragement of Capital Investment) and there have been certain measures of tax relief enacted in view of inflation, the most important of them being inventory relief and accelerated depreciation for industry from 1978 onward and a flat-rate inflation rebate on the amount of tax in tax years 1980 and 1981.

But despite hyperinflation, the method of measuring the profit of a business remained unchanged and income from interest and "linkage"[2] was still liable to income tax and interest and "linkage" charges treated in most cases as deductible expenses. A trader who started the business year with 1 million IS floating capital and ended it with 2 million IS without adding or withdrawing capital would have to pay taxes on an income of 1 million IS, though at 120% inflation in real terms he suffered a loss.

The amendment which introduced an inflation-adjusted tax base had to solve mainly 4 problems:

(1) purely inflationary profits should not be liable to tax;
(2) at the same time inflation should not cause taxation of *less* than the "real" profit;
Taxation of amounts of profits well below the "real" profit occurred frequently for one of the following reasons:
(a) Israeli taxpayers had learned the lessons of inflation and many were used to working with a negative amount of working capital. In that case, the gain from repayment of debts with cheaper money was not fully matched by losses from collecting clients' debts in money of reduced value, or from replacing materials and goods at increased replacement cost. At the same time, business firms invested in quoted securities, the capital gain on which was tax-exempt while the interest on loans financing these investments was deductible. Provisions for disallowance of interest in such cases have not been fully effective;
(b) in many cases direct or indirect inflation relief exceeded the loss from inflation, e.g. where all the inventories were financed by borrowed funds the interest on which is a deductible expense, inventory relief is a pure windfall, not relief from taxation of fictitious profits;
(3) the existing tax law unintentionally encouraged working without own funds, a trend in complete disagreement with other aims of economic policy. Therefore, a change in the law had to remove the incentive to borrow;
(4) the taxation of capital gains had to be supplemented by granting relief for "real" losses, which are not nominal losses. An investor in unquoted shares who sold his investment after 3 years for 5 times the nominal amount invested lost in fact 50% of his investment in view of the tenfold price rise. He would have to pay, however, out of the proceeds of the sale 10% capital gains tax on the purely nominal gain and there are no provisions enabling him to set the "real loss" (50% of the adjusted cost price) against the real profit from another capital transaction where he sold a capital asset for more than the inflation parity (i.e. made a "real" gain).

The new inflation adjustment provisions are to be applied within the framework of the prevailing tax law. The main part of the new provisions is contained in Sections 3 to 8 which deal with the capital maintenance system.

The capital maintenance system

The capital maintenance system applies to all taxpayers who are corporate bodies or partnerships (with very few exceptions specified in the law) who keep their accounts according to the double entry system and base their tax returns on these accounts. The same applies to individuals who carry on a business or profession.

The capital maintenance system includes:
(1) the "capital maintenance allowance";

1. The new law was passed by the Knesset (Parliament) on 12 August 1982 and published on 26 August 1982. It takes effect from tax year 1982 onwards (for most taxpayers starting in April 1982).
2. The terms "linking" or "linking differences" are defined in the general tax code as "any amount added to a debt or claim owing to its being linked to the rate of exchange of a foreign currency, to the consumer price index or another index including exchange differences". The last 3 words were added in order to indicate that loans in foreign currency are for this purpose treated in the same way as loans linked to a foreign currency.

(2) the additional charge (an addition to chargeable income where the erosion of capital due to inflation is a negative amount, i.e. there is a gain from inflation, no erosion);
(3) the adjustment of depreciation;
(4) a flat-rate reduction from the amount of taxable income (as an allowance for the erosion of that income during the year);
(5) the adjustment of the amounts of losses carried forward;
(6) the adjustment to capital gains taxation.

The capital maintenance allowance is based on the excess of capital – according to the balance sheet at the end of the preceding year plus additions less withdrawals – over "protected assets". That excess multiplied by the rise of the consumer goods price index forms the capital maintenance allowance.

Capital includes, in addition to paid-up capital and unallocated profits, many types of loan capital especially long term interest-free or low-interest loans and certain provisions. "Protected" are 9 types of assets enumerated in the "Second Schedule", including unquoted securities, real estate, ships, aircraft, vehicles and goodwill. A common denominator of that group is that their value does not erode through inflation and upon realisation the inflationary element of the capital profit is subject to a low-rate tax only (10%) or is tax-free. Changes in capital and protected assets are taken into account pro rata according to the number of months from the change until the end of the tax year.

The method of calculation of the capital maintenance allowance differs from that in the inflation amendment in the Argentine tax system where the calculation is based on the excess of erosible assets (inventory and monetary assets) over total liabilities. That system is more usual and the above-mentioned Amendment 15 under the Israeli Investment Law also followed it as did the report of the Gabbay Committee of March 1980 on which the new law is based.[3] The new law not only proceeds the other way round but in some important points follows different concepts:

(1) The schedule of "protected assets" for which the taxpayer does not obtain a capital maintenance allowance *excludes* equipment and machinery.
Mainly with a view to encouraging manufacturing industry, by that exclusion machinery obtains full inflation adjustment like inventories and monetary assets. At an annual rate of inflation of 130% and at 20% depreciation the inflation adjustment means a tax saving equal to 65% "real" depreciation in the first and 23% in the second year (see Appendix A).
(2) Quoted securities with very few exceptions are not included in the group of protected assets.
(3) Additions to and withdrawals from the capital of the business, and investment in or realisation of protected assets during the tax year, are accounted for in the calculation of the capital maintenance allowance, including withdrawals by owners and partners and payment of dividends. Apparently for administrative reasons, the Argentine inflation adjustment does not take changes during the year into account.
(4) The amount deductible in the current year from chargeable income in respect of the capital maintenance allowance is in most cases restricted to 50% of the income liable to tax (before deducting that allowance) plus one third of the capital maintenance allowance carried forward from previous years and linked to the consumer goods price index. If any part of the income of a taxpayer consists of the rise in value (mainly linking differences) of Government Bonds, that part is not subject to the above-mentioned limitation.

In the opposite case of a negative adjustment owing to an excess of protected assets over capital (after adjustment for changes during the year), there is no *immediate* addition to the tax charge. The negative adjustment has to be set off against certain other items in the following order:

(1) against losses carried forward from previous years, adjusted for inflation;
(2) against financing expenses;
(3) against the amounts of depreciation adjustment described below;
(4) against the inflationary element in capital gains. The set-off is carried out by way of treating the inflationary profits of the amount set off as a real profit (taxed at ordinary tax rates);
(5) against losses of the current year;
(6) against tax-free income converting such income into normal business income up to the amount set off.

In so far as the amount to be adjusted cannot be fully set off against the 6 above items and provided the taxpayer does not elect to have the amount taxed in the current year as ordinary business income, the amount not used, linked to the consumer price index, has to be treated as business income in the following years to the extent of one third of the amounts so carried over from previous years in every single tax year.

The above adjustment covers about the same ground as 3 out of the 4 adjustments provided for in the Statement of Standard Accounting Practice on current cost accounting in the United Kingdom (SSAP 16), the cost of sales adjustments, the monetary working capital adjustment and the gearing adjustment. The fourth of the adjustments prescribed in SSAP 16, the depreciation adjustment, is provided for in a separate provision of the inflation amendment. Section 4 of the new law provides for an addition to depreciation in proportion to the rise of the consumer price index since the taking into use of the new asset or the date the inflation amendment came into force (beginning of tax year 1982), whichever is later. Naturally, that rule applies only to protected assets because all other assets, including machinery, obtain inflation adjustment by the capital maintenance allowance.

There is one exception to the restriction of the inflation adjustment of depreciation to the period the new law is in force. In cases where during the preceding 3 years no finance expenses have been claimed by a taxpayer, the inflation adjustment can be effected for a period going back to April 1974.

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3. See J.F. Pick, "The Gabbay Report; a proposal for inflation - adjusted taxation of income in Israel", in 34 *Bulletin for International Fiscal Documentation* (1980) at 383.

For reasons of structural symmetry in the new law, the cost of acquisition or improvement of an asset for the purpose of calculating the depreciation includes an allowance for inflation from the date the investment has been taken into account as a withdrawal from capital for the purpose of the capital maintenance allowance to the date of taking it into use.

Losses carried forward during the period the new law is in force are adjusted for inflation. Losses of previous periods are treated as losses of the last tax year before the law came into force (i.e. as losses of the tax year 1981) and are adjusted for inflation since that date.

Capital gains from the sale of unprotected assets will be treated as real gains subject to certain allowances for the period before 1982. Were they to benefit from the reduced tax rate on inflationary gains they would benefit twice because "unprotected" assets are taken into account in calculating the capital maintenance allowance.

In sales of protected assets a real loss (the case where sales proceeds are less than the inflation-adjusted cost) may be deducted from income during the period depreciation would have been allowed on that asset, but for no longer than 5 years.

Section 6 of the law provides for a special deduction of 25% of the inflation-adjusted income for individuals (proposed to be raised to 30%) and of 5% for corporate bodies, apparently as compensation for the erosion of profits during the year.

Profits accrue gradually in the course of the year. If profits are invested in credit to clients or in inventory they suffer erosion; if they are invested in protected assets in the course of the year, the capital maintenance allowance is proportionately reduced. Therefore, a compensation for the erosion of profits is required as one of the elements of the capital maintenance system.

Other provisions of the new law

The provisions concerning the capital maintenance system do not apply to taxpayers entitled to keep their accounts according to the single entry system and keeping them accordingly. These taxpayers obtain the depreciation adjustment only. Interest is fully deductible if used for financing current expenses of the business and for acquisition of unprotected assets on which there is no depreciation. Only 20% of interest expenses for the purchase or improvement of protected and unprotected assets subject to depreciation is allowed.

There is an option for obtaining a full allowance of interest on financing unprotected assets but paying the full rate of capital gains tax on the inflationary profit upon sale, i.e. losing the benefit of the reduced tax rate (10%) on the inflationary element of the capital gain.

Among the other provisions of the new law, two appear to be of special interest. One is a rule charging lenders who granted low-interest loans or interest-free loans to tax on notional interest at 100% p.a. The provision appears to be aimed at preventing tax shifting or tax dodging by transferring income from the lender to the borrower.

Concerning quoted securities the new law abolishes for those taxpayers to whom it applies the tax exemption of the capital gain from the sale of quoted securities. On such securities even unrealised profits will now be taxed every year on the basis of stock exchange quotations. Such treatment contrasts sharply with the continued tax exemption for capital gains from quoted securities held privately.

It would exceed the space of this review to describe other features of the inflation amendment, among which are special provisions for the taxation of banks, mortgage banks, insurance companies and real estate businesses or the treatment of taxpayers required to keep accounts according to the double entry system and not doing so and the treatment of other special cases.

Comment

A large amount of expert work has been invested in preparing the new law and providing a complete set of provisions, on the basis of the proposals of the Gabbay Committee, converting business profits as closely as possible – except by way of keeping fully inflation-adjusted accounting records – from nominal into "real" profits.

As far as can be learned from the experience of the short period since the publication of the new law there are fewer loopholes than would be expected in the case of so far-reaching a change in the basis and the concepts of the taxation of business profits. Some loopholes may be closed by proposed changes which have not yet become law. The authors of the law themselves apparently considered it an experiment in a new field and enacted it for a period of 3 years. It appears, however, that there are a number of shortcomings which may impede application of the new law.

The problem of administration

The first and foremost problem is the lack of skilled staff among the authorities and the taxpaying public who can apply the complicated provisions of the new law.

While a less complicated system – e.g. one without adjustments for changes during the year in calculating the capital maintenance allowance or one with a smaller list of definitions and simpler schedules of own funds and protected assets – may be less fair in allocating the tax burden, the calculated risk of failure of administrative performance that the Israeli tax authorities are taking upon themselves appears to be great and the chances of success only moderate.

Failure would cause damage in many respects beyond the mere loss of tax income. There appears to have been a strong case for applying a less complicated system in the first stage of the inflation adjustment.

The authors of the new law apparently decided as they did because they considered the risk of continued distortions inherent in a less perfect system worse than the risk of faulty administration. That may have been partly due to an optimistic view regarding the possibility of administering the new law successfully.

The regressive 50% clause

The restriction of the capital maintenance allowance to 50% of the chargeable income plus one third of the unused allowances of previous years appears unjustified and regressive.

Taxpayers who earned only a nominal profit but no real profit or only a very small real profit will be strongly affected by that measure and shall continue to pay more than 100% income tax on their real profits or a certain amount of tax on merely fictitious profits while those taxpayers who earn considerable "real" profits will not be affected by the restriction – the inflation-adjustment will generally amount to less than 50% of their profits.

If tax collection were a business, preferential treatment of those "clients" who pay most (i.e. those with a high "real" rate of profit) would appear sensible. Because it is a Government activity the long established principle of progressive taxation should not be disregarded. A deferral of part of the capital maintenance allowance, even index-linked, for those who fail to maintain their capital while those who succeed in maintaining their capital very well do not suffer a deferral appears incompatible with the basic rules of progressive taxation. The more so because capital maintenance is the declared purpose of the main section of the new law.

If it is the fear of a loss of tax income and not consideration of equity or economic policy that has caused the introduction of the 50% limit, the loss of tax income could be reduced by an equal restriction for all taxpayers, as the proposal in the Gabbay report to limit the inflation adjustment to 90%.

Discrimination of dividend payments

The special deduction of 25% (or proposed 30%) for individuals and 5% for corporations in compensation for an erosion of profits should be seen in context with the treatment of dividends and of owners' drawings in an individual business as withdrawal of capital.

While the 30% deduction for individuals appears only slightly lower than the amount which would exactly reflect the erosion of profits by inflation, the 5% allowance for corporate bodies seems to be incongruous with the dividend provision. Where a company gradually distributes its chargeable profit during the year as dividend, the basis for calculating the capital maintenance allowance would be reduced by 25-30% while the allowance under Section 6 would add only 5% to the reduced basis (see Appendix B).

In view of the fact that the capital maintenance allowance is based on the own funds at the beginning of the business year, it appears inconsistent that the distribution of the profit earned during the year reduces the allowance by many times the amount which is added to the allowance under Section 6 on account of the erosion of profits.

The different treatment of the profits earned during the year and the profits withdrawn as dividend is likely to lead to a shift from dividend distribution to increased salaries to managing owners and to greater management fees mainly in private companies. Public companies may be adversely affected by these provisions to the detriment of the shareholding public and without a certain benefit to the Treasury.

Distribution of dividends by companies in Israel is liable to tax in addition to the tax payable by the company (though in most cases it amounts to only about 15% of the remaining amount) and it seems unwarranted to create within the capital maintenance system a disincentive to profit distribution by way of dividend. Such disincentive is, however, created by the provisions concerning the effect of dividend payments on the capital maintenance allowance.

Streamlining the new system

One of the aims of the capital maintenance system is to remove the tax incentive for working without own funds. The tax relief provided by the capital maintenance allowance and the addition to the tax payment for those who work with negative net working capital should have a strong effect in that direction.

But the question may be asked whether the continued tax exemption of capital gains from the sale of quoted securities held privately vis-à-vis their liability to tax even before sale in companies or in the accounts of a private business is likely to encourage in many cases a withholding of funds from business in preference for private investment.

That problem is part of the general question whether the coexistence of business units to which the new law applies, other forms to which different tax rules apply because they keep accounts on the single entry system, companies who opted for inflation adjustment under the investment law and private individuals and branches of foreign companies who remain outside the new law would be likely to create new distortions because of the relations between these groups of taxpayers. A further case of asymmetry may be seen in the fact that the new law grants relief for "real" losses on the sale of business capital assets while individuals outside the law still remain without similar relief.[4]

In discussions of the new law by the Israeli public much attention has been paid to some economic branches the main productive assets of which do not enjoy the benefit of the capital maintenance allowance granted to machinery.

Owners of hotels and truck transport companies complain that the treatment of hotel buildings and trucks as protected assets causes the disallowance, year by year, of finance expenses (for loans granted for building hotels or for buying trucks) while the "protection" of their assets, the low rate taxation of the nominal profit upon the sale of the assets, in most cases takes effect only at a much later date.

There is a strong case for differential treatment of protected and other assets in the matter of the capital maintenance allowance because protected assets obtain

4. The relief applies only to assets subject to depreciation.

full compensation by the linking of their depreciation allowance. Nevertheless, in the economic reality of hyperinflation the method of taxing hotels and truck companies frequently causes severe cash flow problems where part of the basic investment is financed with borrowed funds.

An enterprise set up with 10 million IS share capital and 10 million IS in long term loans and investing those 20 million IS in machinery would at 130% inflation obtain in the first year a deduction of 13 million IS from chargeable income through the capital maintenance allowance on its own funds. A hotel business with the same capitalisation investing its 20 million IS in a hotel building would suffer an addition of 13 million IS to its chargeable income, through the negative capital maintenance allowance on the surplus of protected assets (the hotel building) over its own funds. It would appear that despite the different treatment upon the sale of the capital asset together with the different method of depreciation there remains too large a difference in the treatment of both types of assets especially under the cash flow aspect. A certain degree of tax deferral for operators of protected assets or an option to have them treated as erosible asets may be possible solutions.

Opinion 23 of the institute of Public Accountants in Israel requires firms the shares of which are traded on the Stock Exchange and all firms exceeding a certain minimum turnover to include in the notes to their financial statements details regarding the effect of inflation on their financial results. The inflation adjustment of Opinion 23 and that of the new law, though basically similar, differ in some important details. It would appear highly desirable to remove the discrepancies between the 2 types of inflation adjustment.

Though some changes in the new law in the directions indicated appear most desirable, the 1982 inflation amendment in Israel is an important innovation in the taxation of income, the product of profound thought and research and a valuable contribution to the theory and practice of the taxation of business profits.

It may also help to overcome the psychological barrier to investment in high inflation countries by many potential investors in industrial countries who are afraid of losses due to inflation. Though there are certainly many enterprises in Israel which due to the use of borrowed funds and to the inflation relief granted in the years before 1982 in a simpler way face an increase of their tax burden under the new, not quite complete inflation adjustment of the tax law, the fact of the introduction of an inflation-adjusted tax base may help to remove foreign investors' fears of inflation.

Summing up, it would appear that the success or failure of the system will eventually depend on the ability of taxpayers and tax officials to apply the complicated new law in daily practice.

APPENDIX A

Allowances on machinery under the capital maintenance system

Basic data: Purchase price – 10,000 IS
Rate of inflation – 130% p.a.
Rate of depreciation – 20% p.a.

	1	2	3	4
	Adjusted cost at the end of the year (before depreciation)	*Depreciation*	*Capital maintenance allowance*	*2 + 3 as percentage of 1*
First year	23,000	2,000	13,000	62.22%
Second year	52,900	2,000	10,400 (130% on 8,000)	23.44%
Third year	121,670	2,000	7,800 (130% on 6,000)	8.05%
Fourth year	279,841	2,000	5,200 (130% on 4,000)	2.57%
Fifth year	643,634	2,000	2,600 (130% on 2,000)	0.72%
				100.00%

APPENDIX B

Example of effect of capital maintenance system on gradual distribution of the whole profit of a company during a business year

Basic data: Profit – 100,000 IS
Company tax – 40,000 IS
Dividend distribution:
– 3rd month 10,000 IS
– 6th month 13,000 IS
– 9th month 17,000 IS
– 12th month 20,000 IS

The dividend distributions are considered as withdrawal of capital for the purpose of calculating the capital maintenance allowance (proportionate share from the beginning of the month of distribution).

The calculation of the capital withdrawal based on the above figures is as follows:

$$\frac{10{,}000 \times 10}{12} + \frac{13{,}000 \times 7}{12} + \frac{17{,}000 \times 4}{12} + \frac{20{,}000 \times 1}{12}$$

$= 8{,}333 + 7{,}583 + 5{,}667 + 1{,}667 = 23{,}250$ IS
or 23.25% of the profit of 100,000 IS

At 30% inflation the capital maintenance allowance would be reduced by $\frac{23{,}250 \times 130}{100} = 30{,}225$ IS, i.e. slightly over 30% of the pre-tax profit.

Against this, the company would be allowed a deduction of 5% or 5,000 IS from the taxable profit (Section 6 of the inflation adjustment law).

Additional explanation:

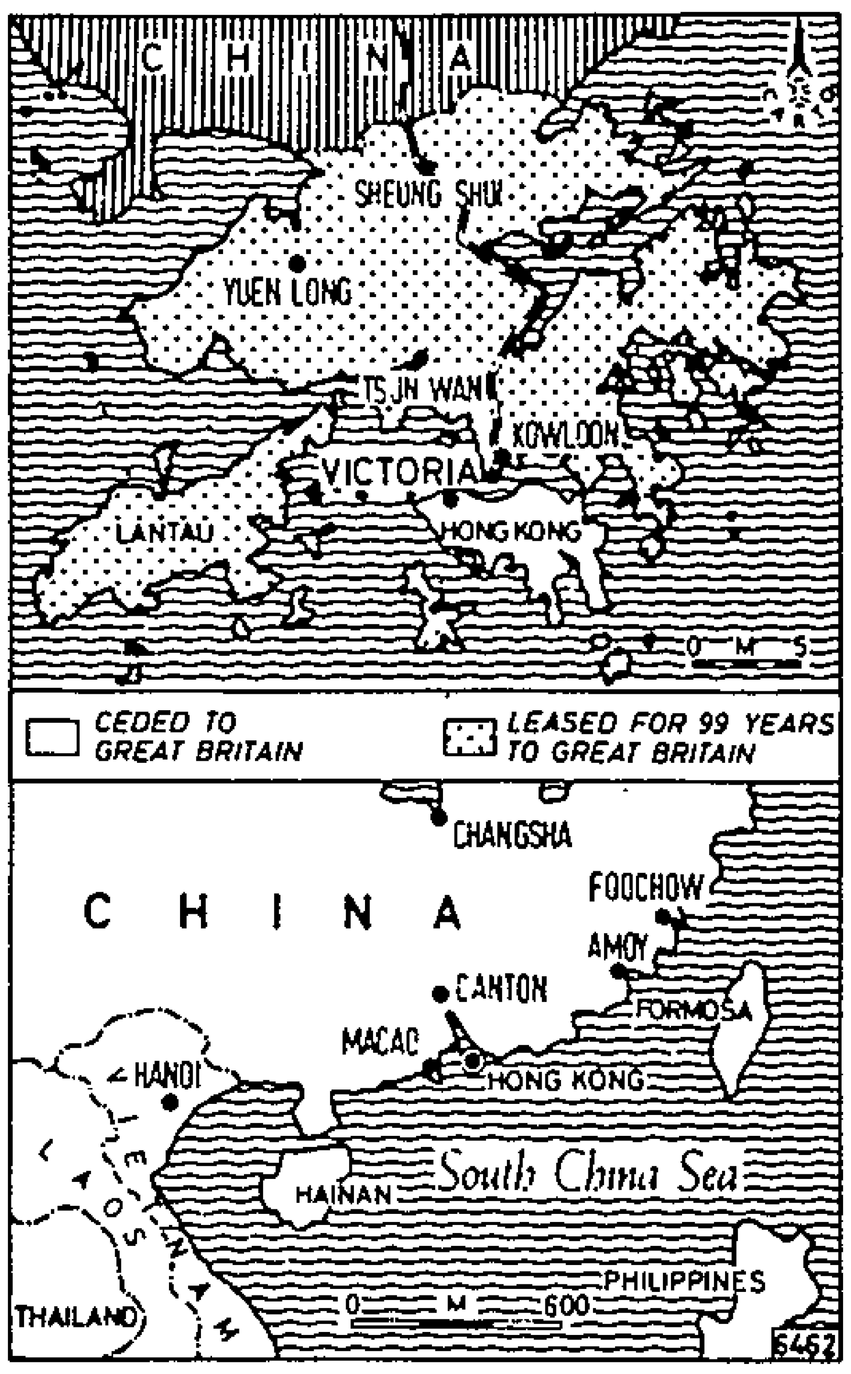
Companies pay 40% company tax. Out of the remaining 60%, 20-35% (i.e. 12-21% of the pre-tax amount) has to be paid as income tax.

Dividend is, however, considered as a deductible expense for income tax purposes (not for company tax). The 60,000 IS dividend shown in our example is gross dividend from which income tax (on account of the shareholder) is deducted at source.

Hong Kong 1983–84 Budget: Tax Proposals

by Y.C. Jao

Hong Kong's 1983–84 Budget, presented on 23 February 1983 by the Financial Secretary, Mr. John Bremridge, contains two important features. The first is that not only was a record deficit reported for the previous fiscal year 1982–83, but that another record deficit was planned for the current fiscal year 1983–84. The other is the steep rise in a variety of indirect taxes and fees in an attempt to reduce the size of the deficit. For a territory renowned for its fiscal conservatism and low taxation, these developments might seem at first sight to be very unusual. This article provides an explanation of the economic background and rationale for the austere budget, and a brief analysis of the revenue proposals.



1. THE ECONOMIC BACKGROUND

In last year's budget for 1982–83, a surplus of HK$2.8 billion was originally envisaged, even allowing for extensive tax concessions.[1] This optimistic forecast was predicated upon a growth rate of the Gross Domestic Product in real terms of 8%, which, though somewhat lower than the double-digit growth in the heady years of 1976–81, was still very robust by world standards. The projection of such a strong growth was in turn based on an assumed scenario of favourable developments: the recovery of the world economy, in particular the U.S. economy, and the continuation of excellent relations with the People's Republic of China, with the implied understanding that nothing would be done to upset the present status quo.

As it turned out, 1982 was a most disappointing year for Hong Kong. The long-awaited U.S.-led recovery of the world economy, on which export-oriented Hong Kong is so dependent, did not materialize. Hong Kong's exports actually declined by 3% in real terms, as against a projected growth of 7%. Unemployment rose from 3.1% at end-1981 to 3.9% at end-1982, while under-employment rose from virtually zero to 2.3% of the labour force during the same period. The severe recession in the export-oriented manufacturing industries soon spread to other sectors. As a result, the real growth of the economy in 1982 plummeted to 2.4%, compared to the predicted 8%. Worse still, economic difficulties were compounded by political uncertainty. In July 1982, the Chinese Government disclosed, via various channels, its intention of recovering sovereignty over the whole Hong Kong area when the lease on the New Territories expires in 1979.[2] This was formally re-affirmed in September 1982, when the British Prime Minister, Mrs. Margaret Thatcher, visited Peking to discuss the future of Hong Kong with Chinese leaders. Although both governments agreed to hold confidential diplomatic talks on Hong Kong with the aim of maintaining the territory's "stability and prosperity", it soon became evident that there is a wide gap between Chinese and British views on the all-important question of sovereignty. Up to the middle of 1982, the apparently cordial relations between China and Great Britain that had developed since the resumption of full diplomatic relations in 1972 encouraged a euphoria that somehow the Hong Kong question could be finessed, given mutual goodwill and common interests. This delusion was shattered when Sino-British differences came out into the open in late 1982, a situation not helped by the Falklands war earlier in the year. The effect on public confidence in Hong Kong was devastating. The Hong Kong dollar, stock market and property prices had all been weakening for some time, but beginning from the second half of the year, their fall became much more precipitate and pronounced. At the time of writing (late March 1983), the Hong Kong dollar has shown some signs of stabilization at a depreciated level (about 9% lower than a year ago on a trade-weighted basis), and share prices have even staged a mild recovery. But the property market remains in the doldrums without any visible signs of a general recovery.

The plight of the property market requires more discussion because of its fiscal consequences. Speculative excesses in 1978–81 had pushed land and property prices to unsustainable heights. By the latter half of 1981, the combination of recession and high interest rates had caused prices to soften, but the downward trend accelerated in 1982 in the wake of growing apprehension and uncertainty about Hong Kong's future, and the failure of a number of finance companies and property firms which had over-extended themselves in the real estate market. Depending on location and other attributes, land prices fell by 30 to 55%, while property prices fell by 15 to 45%, from their peaks in 1981. In Hong Kong, all land is legally owned by the British Crown, and the Hong Kong Government as its agent merely sells or grants leasehold interests only, or, in other words, there is no permanent freehold. Crown leases, sold at public auctions to the highest bidders, used to be for terms of 75, 99 or 999 years, but they have now been standardized in the urban areas of Hong Kong and Kowloon to a term of 75 years, renewable for a further 75 years on payment of a reassessed Crown rent (land tax). In the New Territories and New Kowloon, land leases are normally sold for the re-

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1. See Jao, "Hong Kong: More Tax Concessions", *37 Bulletin for international fiscal documentation 5* (1982) at 195.
2. The "whole Hong Kong area" comprises the island of Hong Kong, the Kowloon Peninsula, and the New Territories. Hong Kong Island was ceded to Britain in 1842 after the Opium War, the Kowloon Peninsula ceded in 1860, and the New Territories leased in 1898 for 99 years.

sidue of a term of 99 years less 3 days from 1 July 1997.

Under such a land tenure system, the Government can reap windfall profits from land sales when the real estate market is booming and land prices are soaring; but by the same token, when the property market is falling there can be an exaggerated impact on land sales, since it is a well-known and documented feature of the real estate cycle that rent lags behind property prices, which in turn lag behind land prices, in both the upward and downward directions. During the great property boom of 1978–81, the value of land sales increased nearly ten-fold from HK$1,831.3 million to HK$10,769.8 million. The Government's mistake in planning last year's budget was to assume implicitly that this high level of land revenue could continue without serious disruption. Thus, land sales were estimated to bring in some HK$12,452 million, accounting for nearly 100% of capital revenue and about one third of total revenue.

The collapse of the property market has therefore thrown the whole budget off balance. Land sales are now expected to be some HK$7,300 million lower than the original estimate, constituting the whole of the shortfall on capital account. On the current account, the effect of the economic recession results in a revenue shortfall of some HK$1,400 million. Although some reduction in both current and capital expenditures has been made, this still leaves an estimated overall deficit of HK$3,800 million for 1982–83, a historical record.[3]

For the current fiscal year 1983–84, the economic recession and depressed property market have been taken into account, and this has resulted in a revenue shortfall of some HK$6.2 billion. However, while the cyclical effects on land sales and other tax revenues are important contributory causes, they cannot explain wholly the size of the record budgeted deficit. In recent years, Government expenditures have grown rapidly, generally at a higher rate than Gross Domestic Product (GDP), as a result of which the relative size of the public sector more than doubled from 11.2% in 1970–71 to 24.2% in 1982–83. Social pressures have undoubtedly been the dominant reason for this structural trend, but an upward bias has also been embedded in the fiscal system by the rapid expansion of the civil service and the sharp annual increases in its salaries. Given that "personal emoluments" now regularly account for about 38% of current expenditure, the bureaucratic explosion has built up serious fiscal strains and stresses. Even in the current fiscal year, when it is faced with bleak economic prospects, the Government is only able, or willing, to restrain the growth of the bureaucracy to under 5%, but not to freeze the size of the civil service at the existing level.

2. REVENUE PROPOSALS

The estimated deficit of 1982–83 and the budgeted deficit for 1983–84 are both record figures.[4] In the past, fiscal prudence has resulted in the accumulation of a sizeable reserve, amounting to some HK$22,571 million at 1 April 1982. After absorbing the projected deficit of HK$3,876 million for fiscal year 1982–83, the fiscal reserve available at 1 April 1983 is estimated at about HK$18,700 million. Allowing further for some contingent liabilities, the free fiscal reserve at the disposal of the fiscal authorities is about HK$11,500 million. This, in the Government's view, is inadequate for absorbing a fiscal deficit on a continuing basis. At the same time, the Government is also reluctant at this stage to resort to large-scale borrowing merely for the purpose of covering the deficit, its philosophy being that borrowing should be avoided unless it is specifically used for financing long-term infrastructural or other income-yielding projects. Given these constraints, the strategy finally adopted by the Financial secretary is to cover the planned deficit for the current fiscal year partly by drawing on the fiscal reserve, and partly by increased taxation.

Granted that increased taxation is inevitable, there is still the problem of whether direct or indirect taxes should be chosen. The Government's view is that, given the present political uncertainty over Hong Kong's future, and the current recession, any increase in direct taxation on profits and personal income will have a significant impact on public confidence and economic incentives, especially as neighbouring countries are capitalizing on the "1997 syndrome" by offering various financial inducements to attract capital and entrepreneurship from Hong Kong. In comparison, the adverse effects of higher indirect taxation seem more tolerable. Moreover, in recent years, according to the Government the relative mix of direct and indirect taxation has moved against the former, so that some redress is called for.

Against this background, we can now briefly describe the various revenue proposals contained in the current budget. The higher levies may be divided into two major categories, namely, indirect taxes and fees.

A. Indirect taxes

The duty rates on liquor were approximately doubled, while those on tobacco were quadrupled, effective from 23 February 1983. For both fiscal and transport policy reasons, the duty rates on motor spirit and diesel oil were increased by 67% and 185% respectively, but the latter did not apply to diesel oil used by enfranchised public buses, in order to encourage more use of public transportation (and, by implication, discourage the use of private vehicles). Details are contained in the summary to the Budget, on page 269.

Two taxes that affect the travel industry were raised, the hotel accommodation tax from 4% on room charges to 5%, and the airport departure tax from HK$20 to HK$100, the former effective from 1 April 1983, the latter from the date of new legislation.

Betting duties on horse racing, a favourite gambling activity in Hong Kong, were increased in the following manner: from 7½% to 8½% on standard bets, from 11% to 13½% on exotic bets, and from 25% to 27% on lotteries. These increases all took effect from 1 April 1983.

3. In Hong Kong, the fiscal year begins on 1 April and ends on 31 March. The estimated overall deficit is based on the current situation at end-1982, or a maximum of 8 months' performance. The final outcome may still be quite different.

4. In the post-World War II period, small deficits were recorded in 1946–47, 1959–60, 1965–66, and 1974–75. In all other fiscal years, surpluses of varying amounts had been achieved.

"Rates" are, in the British tradition, a form of accommodation tax levied for the provision of urban services to occupants of residential dwellings. Effective from 1 April 1983, the percentages on Government-assessed rental values were raised from 11½% to 13½% in urban areas and from 11% to 13½% in the New Territories. Since rating in the New Territories is being phased in over a 5-year period, the average percentage for 1983–84 will be about 9%.

B. Licences and fees

Effective from Budget Day, 23 February 1983, the driving licence fee was tripled, while the annual vehicle licence registration fee was increased by an average of about 80% for various types of goods vehicles, taxis, private cars, private light buses, etc. For details, the reader is again referred to page 269.

Fees levied on ships mooring at Government buoys were more than doubled from HK$700 to HK$1,500 a day for a Class A buoy and from HK$450 to HK$1,000 a day for a Class B buoy, both to take effect from 1 April 1983.

The registration fee for both incorporated and unincorporated businesses was doubled from HK$150 to HK$300 per annum, effective from 1 April 1983. For newly incorporated companies, the registration fee was doubled to HK$600. The additional ad valorem charge was increased from HK$4 to HK$6 for every HK$1,000 of share capital. Both these new fees took effect from 23 February 1983.

The annual licence fee for banks was increased by 50% to HK$300,000 and for each local branch (or sub-branch) also by the same percentage to HK$15,000, effective from 1 April 1983.

3. OTHER PROPOSALS

Not all revenue proposals in the current budget were for tax or fee increases. There were in fact two minor tax concessions. One was that payments for the acquisition of patent rights to upgrade existing technology in production would be tax-deductible for both final profits tax assessments for 1982–83 and provisional profits tax assessments for 1983–84. The other was the increase in the dependent parent allowance by HK$2,000 in respect of each dependent parent actually living with the taxpayer throughout the year. This concession would also be back-dated to 1982–83.

Regarding the controversial proposal of separate taxation for married women which has been pressed by feminine groups, the Financial Secretary did not regard it as feasible in Hong Kong for foth fiscal and social reasons. However, he did promise to delete discriminatory and offensive provisions against women in the existing legislation.

The Financial Secretary also decided to accord, effective from 1 April 1983, the status of "specified liquid assets" to certificates of deposits denominated in Hong Kong dollars or in a foreign currency issued by licensed banks and licensed deposit-taking companies in Hong Kong. This is a policy change for which financial institutions have long campaigned, arguing that it will add to the sophistication of the money market and Hong Kong's stature as a financial centre. However, no individual bank or deposit-taking company may count such assets exceeding 2% of its deposit liabilities as defined for the calculation of the statutory liquidity ratio.

4. CONCLUSIONS

A combination of adverse economic and political factors has caused a radical change in the state of Hong Kong's public finances. The projected surplus for fiscal year 1982–83 has turned into a record deficit. In the current fiscal year 1983–84, another large deficit has been budgeted even after a steep rise in indirect taxes and fees.

Within the category of purely economic factors, the deficit is attributable to cyclical and structural causes. For a cyclical upturn in tax revenue, much depends on the beneficial effects on Hong Kong of the expected world economic recovery led by the United States. However, even if this should happen this year, the impact on tax revenue would not be immediate, given that current tax assessment is based on the previous year's business or personal income. Moreover, unless the property market picks up sharply, or the uncertainty regarding Hong Kong's future is removed (the two are in any case related), Government land sales will remain depressed for a long time to come. Another deficit for the next fiscal year 1984–85 seems inescapable.

Even more intractable is the structural cause for rising expenditure. As mentioned in the text, the two major determinants of the structural change are rising social pressures and rapid growth of the civil service. While growing pressures for increased spending on social services are understandable, being a universal trend to which Hong Kong is not immune, the Government has not really come to grips with the costly consequences of bureaucratic expansion.

In choosing between two lesser evils, the Government is probably justified, in the current situation, in relying mainly on indirect rather than direct taxation. However, in raising sharply various indirect taxes and fees, it has underestimated the consequences of their regressive incidence. Most of the increases are immediately shiftable to the final consumers, and because many items are represented in the consumer price index, the jump in inflation is likely to generate much social discontent, even in a society like Hong Kong where labour-management relations are reasonably good.

To conclude, the halcyon days of chronic fiscal surplus for Hong Kong are over. A long period of difficult decisions and challenges awaits fiscal policy-makers.

HONG KONG: 1983/84 BUDGET A SUMMARY

by Cameron G. Greaves of Deloitte Haskins & Sells, Hong Kong

The Financial Secretary included the following changes in the proposals presented to the Legislative Council in the Appropriation Bill 1983 (the Bill):

1. Salaries tax

The Dependent Parent Allowance will be increased from $8,000 to $10,000 for the purposes of final assessments for 1982/83 and provisional assessments for 1983/84.

2. Profits tax

The cost of purchasing patents will be deductible. This provision will apply for the purposes of final assessments for 1982/83 and provisional assessments for 1983/84.

3. Other taxes

Bank licence fees will be increased by 50%, viz.:
(a) annual fee: from $200,000 to $300,000, and
(b) local branch: from $10,000 to $15,000 (each)
Company fees will be increased with effect from 24 February 1983 as follows:
(a) initial registration from $300.00 to $600.00;
(b) ad valorem capital duty from $4 per $1,000 to $6 per $1,000.

Business registration fees
The ordinary business registration fee is to be doubled. The annual charge will be $350.00 with effect from 1 April 1983.

Hotel Accommodation Tax will be raised from 4% to 5% with effect from 1 April 1983.

Rates will be increased as follows with effect from 1 April 1983:

	From	To
Urban areas	11.5%	13.5%
New Territories	11.0%	13.5%

Buoy fees will be increased with effect from 1 April 1983. The new fees will be:

Class A	$1,500 per day
Class B	$1,000 per day

The old daily fees were $700 and $450 for classes A and B respectively.

Vehicle and driving licence fees will be increased as follows:

	Old fee $	New fee $
Driving licence fees		
Provisional licence	100	300
Driving test	150	300
Driving licence – 1 year	50	150
– 3 years	150	450
Vehicle licence		
Private cars: up to 1,500 c.c.	1,800	2,300
1,501 to 2,500 c.c.	2,700	3,400
2,501 to 3,500 c.c.	3,600	4,500
3,501 to 4,500 c.c.	4,500	5,600
Over 4,500 c.c.	5,400	6,700
Goods vehicles: up to 20 cwt	400	700
over 20 cwt but below 45 cwt	800	1,400
over 45 cwt but below 75 cwt	1,200	2,100
over 75 cwt	1,600	2,800
Motor cycles	600	750
Taxis	900	1,600
Private light buses	900	1,600

Betting and lottery duty will be increased as follows:

	From	To
Standard bets	7.5%	8.5%
Exotic bets	11.0%	13.5%
Lotteries	25.0%	27.0%

Airport departure tax will be increased from $20 to $100 per passenger.

Duty was increased as follows:

Tobacco:	Per kilogramme From	To
Imported cigars	43.65	175.00
Imported cigarettes	44.45	178.00
Chinese prepared tobacco	8.15	33.00
Other imported manufactured tobacco	35.05	140.00
Unmanufactured tobacco of Malawi origin	32.20	130.75
Other unmanufactured tobacco	32.85	131.40
Hydrocarbon oils	Per litre From	To
Motor spirit and aircraft spirit	1.20	2.00
Diesel oil for road vehicles	0.35	1.00

In addition to the above Mr. Bremridge proposed general increases in duty on liquor. If these are passed on in full to the consumer, he estimated that the increase in retail prices of the more popular categories of beverage would be as follows:

	Increase
Brandy (per bottle)	$30
Whisky (per bottle)	$20
Table wine (per bottle)	$ 7
Beer (per can)	$0.15 to $0.20

Subsequent to the Financial Secretary's presentation the debate on his proposals was adjourned. It will be resumed on March 23 and 24, 1983 at which time Unofficial Members will express their views. Official Members will respond on April 13, 1983 and the debate will be continued into April 14, 1983 if necessary. The third reading of the Bill will take place on 27 April 1983.

It is to be noted that it is intended that the date for future Budget Days will be moved from the last Wednesday of February to the last Wednesday of March in order to assist in the preparation of estimates.

HONG KONG: Budget 1983-84

Extracts from the Budget speech pronounced by the Financial Secretary, Mr. John Bremridge, on 23 February 1983

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

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NEW TAXATION

86. The question arises of how this additional taxation can best be raised. Even if unpopular it must be accepted as fair by the reasonable majority, who can see that there are no easy options. It has been exceptionally difficult to devise a balanced approach which will produce the required yield.

87. As employment and exports depend on the maintenance of investment and reinvestment, it is in my opinion inopportune now to increase the tax on the profitability of businesses. I believe that this view is widely accepted and I do not indeed propose any increase in profits tax.

88. Insofar as salaries tax is concerned, an obvious way substantially to increase the yield is to reduce the allowances, which would also bring into the salaries tax net many of those who now pay nothing. But I am aware of the problems of the lower paid. Further, I believe strongly that the economic success of Hong Kong owes much to low direct taxation; I suspect that a change in this approach even if necessary might result in unforeseen effects; and finally I consider that while all benefit from low taxation the fact that most workers can pocket their wages plus possible overtime without needing to pay any direct tax is one of Hong Kong's most important spurs to productivity.

89. There is yet another factor. The ratio between direct and indirect taxation moved from 57:43 in 1977–78, to 64:36 in 1981–82 and to 69:31 in 1982–83. The drift indicates[1] that the balance between direct and indirect taxation has shifted against indirect taxation. This arises for clear reasons i.e. higher productivity of direct taxation plus the large surpluses accrued in recent years, which have made raising taxes unnecessary.[2] In brief our tax system has become unbalanced, and there is a case on these grounds alone for increasing the level of indirect taxation.

90. This brings with it one other advantage. I believe that there are attractions in systems of taxation based on expenditure rather than income, and it seems to me as a generalisation that those who choose to spend on such pursuits as drinking, smoking or owning motor cars can reasonably expect to be taxed more highly than those who do not. These taxes can be avoided. If you do not wish to pay them you do not need to. Admittedly not all my proposals carry this justification. Some are the creatures of necessity as we cast around for increased revenue without unacceptable side-effects or obvious drawbacks. But I propose to raise \$3 billion in additional taxation almost entirely from indirect taxes.

91. I have eleven proposals for increasing revenue, which I estimate in 1983–84 will bring the necessary \$3 billion. Four of the proposals come into effect today under Revenue Protection Orders which Your Excellency signed this morning, and are detailed in Appendix D to the printed version of my speech. The remaining seven will come into effect on 1st April 1983, or as soon as the necessary legislation has been enacted.

DUTIABLE COMMODITIES

Liquor

92. My first proposal increases the duty rates on dutiable commodities. The duty rates on liquor were last revised in 1975, and since then the incidence of duty in retail prices has fallen to a point where, in many instances, it is half what it was at the last revision. I propose to restore the incidence by roughly doubling the duty rates, effective from this afternoon.

93. It is for the trade to determine their selling prices, but assuming that the increased duties are passed on to consumers in full, the increase in the retail price of a bottle of brandy may be \$30, of whisky about \$20, of table wine about \$7 and of a can of beer 15 to 20 cents, all depending of course on the brand. The main duty rates should bring in an additional \$300 million in 1983–84.

94. The present basis of levying duty on liquor per measure is open to criticism even though simple to enforce. There seems no reason in logic why purchasers of cheaper brands in a class of drinks should pay exactly the same duty per bottle as required for an expensive brand. I will therefore consider submitting new legislation later, which will propose changing the basis of levying duty on alcohol to an ad valorem rather than the present unitary system. It must be understood that at present this represents no commitment – except to a study.

Tobacco

95. The incidence of duty in retail prices for cigarettes has similarly declined since they were last revised in 1978. The price of cigarettes, cigars, and tobacco in Hong Kong is still very low by world standards, and we clearly now need to raise additional revenue. I therefore propose not only to restore the incidence, but to look for even further revenue by increasing the current duty rates on tobacco by four times, effective from this afternoon.

96. Assuming that these increases are passed on to the consumer in full, the increase in the price of an average packet of 20 cigarettes may be about \$1.50 for Hong Kong made brands and \$2 to \$2.50 for imported brands. I estimate that an additional \$900 million in revenue should be obtained in 1983–84 as a result of these increases, even after allowing for reduced demand – no bad thing in itself.

Hydrocarbon oils

97. The Dutiable Commodities Ordinance also provides for duties on hydrocarbon oils. The duty rates were revised only last May for transport policy reasons, whereas the last revision for fiscal reasons was made as long ago as 1976. Since 1976, and ignoring the increases of last May, the incidence of the duty in retail prices has declined. I propose to restore the incidence and then to add back the May increases. This means increasing the duty rate on motor spirit from \$1.20 to \$2 a litre.

98. The duty rate on diesel oil for road vehicles was not altered last May. To restore the original incidence, I propose to increase the duty rate from 35¢ to \$1 a litre. These two increases are again effective from this afternoon.

99. In order to avoid imposing an additional burden on public transport users who tend to be the less well off, the increased duty rate will not apply to diesel oil used by enfranchised public buses. This will be achieved by introducing an arrangement whereby the increase of 65¢ a litre on diesel oil used on enfranchised public buses will be refunded. I estimate the net additional revenue yield in 1983–84 will be about \$530 million.

DRIVING LICENCES

100. My second proposal increases with immediate effect the fees for provisional driving licences, annual driving licences and driving tests which were last revised as long ago as 1973. Costs have increased by at least three times since then, and I therefore propose that the fee for a provisional driving licence should be increased from \$100 to \$300 and that for an annual driving licence from \$50 to \$150. For a driving test I propose to double the fee, from \$150 to \$300, because failures at the first attempt are fairly common and tripling would fairly be regarded as excessive. The new fees should yield an additional \$90 million in 1983–84.

VEHICLE LICENCES

101. My third proposal increases, again from this afternoon, the licence fees for the annual registration of motor vehicles. These are tax-loaded, and the last revision of the tax-loading was carried out in 1979. But last May the licence fees for private cars and motor cycles were increased for transport policy reasons.

102. I propose that the 1979 fees should be adjusted upwards, ignoring the selective

1. 1982 B.S., note 6 Appendix A.
2. In the light of our policy of raising taxes normally for fiscal purposes only.

loading introduced last May, to restore the tax value, and that the May loading should then be added back to obtain the new fees. I calculate the 1979 fees need to be increased by about 80% which means, for example, that the licence fee for a small car of up to 1,500 c.c. will be increased from $1,800 to $2,300.

103. No loading was added last May to the fees for goods vehicles, taxis and private light buses. Their fees will thus be increased by roughly 80%.

104. The additional revenue yield from the increased fees for 1983–84 is estimated at $220 million.

BUOY FEES

105. My fourth proposal increases the fees levied on ships mooring at Government buoys, which were last revised in 1979 when they were set to recover costs and provide tax revenue. The ratio of cost recovery to tax loading was 25:75. To restore this ratio in the light of increased costs since 1979, I propose to increase the fee for a class A buoy from $700 to $1,500 a day, and for a Class B buoy from $450 to $1,000 a day. These new fees will take effect from 1st April 1983 and should bring in an additional $20 million in 1983–84.

BUSINESS REGISTRATION FEE

106. My fifth proposal concerns business registration fees. An annual registration fee of $175 is presently payable by all persons carrying on business and by all companies registered under the Companies Ordinance. There are exemptions for small businesses whose monthly turnover does not exceed certain prescribed limits. The present fee of $175 was fixed in April 1979. Having regard to the fact that it is a tax loaded charge, there is clearly a case for an increase simply to take account of increased costs. Additionally, however, I have been influenced by the fact that for a variety of reasons many people who carry on business here make little or no other contribution to the exchequer.[3] I believe, therefore, that there is a good case for a substantial percentage increase in business registration fees, for by any standards the charge is modest. Accordingly, I propose to double the rate of the annual business registration fee from its present level of $175 to $350 per annum. The increased fee will be effective from 1st April 1983 and is estimated to produce an additional $60 million annually.

COMPANY REGISTRATION FEE

107. My sixth proposal increases the company registration fee charged under the Companies Ordinance. The fee is at present $300. As I am proposing that the business registration fee should be doubled to $350, I also propose that the company registration fee should be doubled to $600. The additional ad valorem charge of $4 for every $1,000 of share capital would also be increased, but only to $6.

108. The new fees will be effective from midnight tonight and should bring in additional revenue of about $90 million.

HOTEL ACCOMMODATION TAX

109. My seventh proposal concerns the Hotel Accommodation Tax, which was introduced in 1966 and is levied on room charges. The present rate of tax is 4%, and the yield is for all practical purposes earmarked for payment of the majority of the annual subvention to the Hong Kong Tourist Association.

110. The hard working Hong Kong Tourist Association receives an annual grant from the Government calculated on the basis of the yield from the tax plus an additional amount made up from General Revenue equivalent to a tax yield of 2%. I am anxious that the tax should cover the total grant. I therefore propose to increase the rate of tax to 5%, thereby reducing the contribution from General Revenue to the equivalent of a tax yield of 1%, and further to eliminate this contribution over four years by a one-quarter percentage point reduction each year. Thus for 1983–84 the Association's subvention will be equivalent to the tax at 5¾%, the tax itself producing 5% and General Revenue contributing ¾%. The total subvention should still provide the Association with an increase in money terms in 1983–84 in line with the guidelines I adopted for public sector expenditure.

111. The increased rate of tax of 5% will come into effect on 1st April 1983, and is estimated to yield an additional $15 million in 1983–84. I do not believe that this modest increase of say $4 per night will discourage the growing number of tourists who come to Hong Kong.

BETTING DUTY

112. An obvious source of increased revenue is the betting duty. In the current year, 1982–83, Hong Kong's punters are expected to hazard about $13 billion on horse race bets on the Jockey Club tote and on Mark VI lotteries, yielding to the exchequer in betting duty about $1.2 billion. The yield from this source, however, is in my opinion a relatively small contribution in the light of present circumstances.[4] My eighth proposal therefore is to increase the betting duty from 1st April. In doing so, however, I have been conscious of the need not to drive punters into the arms of illegal bookmakers, avoidance of which is a major purpose of our policy on betting. My proposals are consequently structured so as to avoid this possibility.

113. The present rates of betting duty are 7½% of the amount of each "standard" bet and 11% of the amount of each so-called "exotic" bet made on the Jockey Club tote.[5] The balance of the tote pool after deduction of betting duty is allocated as to 90% to punters by way of prize money and the remainder to the Jockey Club as commission. The proceeds of Mark VI lotteries are sub-divided as to 25% duty, 15% to the Lotteries Fund and to the Jockey Club, of which a minimum of 5.75% goes to the Fund, and the balance of 60% to prize winners.

114. In setting new rates of duty, therefore, I have been at pains to ensure that the pool available for prizes is not diminished unduly. Accordingly, I propose –

firstly that the duty on standard bets be increased from 7½% to 8½%, but with a corresponding reduction in the level of commission to the Jockey Club – that is to say *no* reduction in the size of the prize money pool.

secondly that the duty on exotic bets be increased from 11% to 13½%, with a reduction of 1% in the level of commission to the Jockey Club and a reduction of 1½% from the punters' share. This will mean, in effect, that the pool of prize money will be diminished to a minor extent, from 80.1% of total bets placed to 78.6%.[6]

thirdly that the duty on lotteries be increased by 2% from 25% to 27%, with a corresponding reduction of 2% in the level of the Jockey Club and Lotteries Fund share. The pool available to prize winners thus remains unchanged.

115. These proposed increases in betting duty are estimated to produce an additional $220 million in 1983–84, of which some $26 million will come from punters on exotic bets, $6.25 million from the reduced contribution to the Lotteries Fund and the considerable remainder by way of reducing the Jockey Club's share.

BANK LICENCES

116. My ninth proposal is to increase the license fees for banks. These were last revised in 1975 when they were given a royalty loading of four times the amount strictly required for cost recovery. The cost of supervision has doubled since then. However, I propose to increase the licence fees by 50% only. This means the annual fee for a licence will increase from $200,000 to $300,000, and for each local branch from $10,000 to $15,000.

117. There are equally compelling arguments for revising the fees for deposit-taking companies, but for obvious reasons I do not propose to do so at the present time. Increases will, however, be necessary sooner or later.

118. The new bank licence fees will take effect from 1st April 1983, and I estimate the additional revenue for 1983–84 at about $25 million.

RATES

119. My tenth proposal concerns the controversial subject of rates. The maintenance of a fair base on which to assess rates (and also property tax) has long presented difficult problems. Members will all understand that the base itself does not set the return, which depends on the rate of tax or poundage. Thus

3. There are those, for example, who pay little because our limited territorial source criterion excludes a substantial part of their profits from charge to tax; there are others who pay little because our generous personal allowances minimise their liability under the personal assessment arrangements. Others are able to reduce their basic liabilities via tax loss companies, and so on.
4. Even though the Jockey Club itself makes considerable grants to community projects.
5. "Standard" bets are win, place, double and quinella bets: "exotic" bets are all other forms of bets.
6. Because of the extremely high odds paid out on exotic bets by the Jockey Club there is little chance of a swing to illegal bookmakers.

the course of the Inland Revenue Amendment Bill (1983)[7] through this Council does not reflect any intention on my part to increase the yield from property tax, but only to make sure that it is assessed on a more obviously fair actual rental basis.

120. Similarly the Government's announced intention to conduct an exercise to determine new rateable values for 1984–85 is not designed to increase the return from rates, but to ensure that the burden of the charge is equitably spread between different classes of ratepayers.

121. The existing General Rate percentages are 3½% in the urban areas and 11% in the New Territories. The Urban Council Rate in the urban areas is 8%. The present rateable values, to which these percentages are applied to determine the charge to rates, were established as long ago as 1976 and are now hopelessly out of date. As I have said, a revaluation exercise is being carried out, and new values will apply from 1st April 1984.

122. When these new rateable values have been determined the poundage will have to be adjusted. The estimate for 1983–84 of $777 million is less in money terms than it has been in each year since 1978–79.

123. I propose, therefore, with effect from 1st April 1983 to increase the General Rate percentage for the urban areas from 3½% to 5½%, making a total including the Urban Council Rate of 13½%. I propose to increase the General Rate for the New Territories from 11% to 13½% to bring it into line with the total for the urban areas.

124. For the urban areas this will mean a 17.4% increase in the rates payable by a ratepayer. The increase on average for a typical small tenement will be about $10 a month, and for a large flat about $100 a month. Even so and however necessary I appreciate that this increase will affect many people at a difficult time.

125. I would nevertheless remind Members that in public housing estates the initial burden will be borne by the Housing Authority. I would also ask Members to note that rates payments are deemed to be part of rent for public assistance.

126. In certain areas of the New Territories rating is being phased in over a five year period. For these areas the percentage for 1983–84 would have been 9%. My proposal will bring this to 11%.

127. In estimate that the additional yield from the General Rate for 1983–84 will be about $300 million.

AIRPORT TAX

128. I come to my eleventh and last proposal. A passenger service charge is levied on airlines at the rate of $20 for each adult passenger. I propose to abolish this charge, which the airlines in any case pass on to their passengers, and to introduce in its place a specific tax on departing passengers. I propose to set the tax initially at $100 for each passenger – children will continue to enjoy a concessionary rate.

129. New legislation will be required, and administrative arrangements with the airlines will have to be made for the collection of the tax. My intention is to introduce the necessary bill to this Council as soon as possible, so that the new tax will take effect as early as possible in the next financial year. Assuming ten months' yield from the tax, additional revenue for 1983–84 should be about $230 million.

130. Although the main thrust of my revenue proposals this year must necessarily be to increase taxes, they include two concessions and one reform.

BUSINESS TAXATION

131. Last year I introduced measures which gave improved capital allowances in respect of expenditure incurred on the provision of plant and machinery and on the acquisition of industrial buildings.[8] It has been represented that a further appropriate incentive could be provided by permitting deductions for profits tax purposes in respect of royalty payments for patents acquired with a view to upgrading existing technology.[9] I agree.

132. My *first* tax concession is consequently that once and for all payments for the acquisition of patent rights for use in the production of profits chargeable to profits tax should become deductible expenditures. This treatment is not inconsistent with that already accorded to expenditure on scientific research, with which the acquisition of patents might be said to be similar.

133. A deduction will therefore be granted in the year in which the expenditure on acquisition is incurred. The new deduction will apply to both final profits tax assessments for 1982–83 and provisional profits tax assessments for 1983–84. The cost to the revenue of this proposal will be about $8 million in 1983–84 and $5 million in a "full" year.

PERSONAL TAXATION

Dependent parents

134. Last year, when introducing a proposal to increase the dependent parent allowance from $7,000 to $8,000 I undertook to give further thought to the important social question of persuading tax paying children to look after their ageing parents.[10] I now propose to introduce a new additional dependent parent allowance of $2,000 in respect of each dependent parent actually living with the taxpayer throughout the year. Floating grannies will not be accepted. Thus the dependent parent allowances will total $10,000 for each qualified dependant.

135. The new additional allowance will apply to both final salaries tax assessments (and to personal assessments also) for 1982–83 and provisional salaries tax for 1983–84. The cost to the revenue in 1983–84, after allowing for the two instalment systems for the payment of provisional salaries tax, will be $16 million and $9.5% million in a full year at present levels of chargeable income. I estimate that some 20,000 taxpayers or approximately 70% of those who currently claim dependent parent allowances will benefit from the new additional allowance.

Separate taxation for married women

136. I turn now to a reform measure involving the contentious question of separate taxation for married women. Last year I felt unable to recommend any fiscal changes relating to married women. I did, however, undertake to look into the matter further.[11] Since that time the subject of separate taxation has received considerable airing in the media; and I have received a number of representations. Some have been persuasive.

137. The question of how best to charge to tax income accruing to the family unit – and in particular whether the income of married women should receive special treatment – has been widely debated. Various methods have been adopted in other tax administrations, but none has received universal approval. A number of options and indeed a wide variety of permutations of those options are to be found elsewhere. All have their merits in the context of their own particular environments. None is necessarily right for Hong Kong.[12]

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7. The Inland Revenue Amendment Bill (1983) will change the basis for property tax from an assessed valuation basis to an actual rental basis.
8. 1982 B.S. paras. 81–83. (See 36 *Bulletin for international fiscal documentation* (1982) at 271. Hereinafter cited as "BIFD".
9. In regard to patents generally, the present position under the law is that royalty payments for the *use* in Hong Kong of patent designs are deductible if, firstly, the patent is used in the course of producing profits chargeable to profits tax and, secondly, the royalty payments are calculated having regard to the extent of use of the patent; for example by reference to the quantum of production or sales of the product being manufactured under patent. Where, however, patent rights are acquired by way of a once and for all lump sum payment, such a payment is, on general principles, of a capital nature and non-deductible. Furthermore, because of the capital nature of these payments they, at present, enjoy no relief whatsoever; they are not deductible as expenses for profits tax purposes and they do not qualify for depreciation allowances under the capital allowances provisions.
10. 1982 B.S., paragraph 94. (36 BIFD (1982) at 273).
11. 1982 B.S., paras. 105–109. (36 BIFD (1982) at 274).
12. There are four basic routes that we might in theory take –
(a) *Firstly,* we might mandatorily adopt a system of separate *taxation;* that is to say a system which abandons the concept of the family as a unit of taxation and proceeds on the basis that each party to the marriage is to be treated as a single person, chargeable and accountable for the payment of his or her taxes without reference to marital status. Such a system would however –
    (i) lead to inequity as between similar families with similar total incomes (unless, of course, the tax structure was radically changed to remove the tax advantages of separate taxation);
    (ii) call in question the validity of continuing to grant child allowances and dependent parent allowances to persons whom the system would for all practical purposes otherwise regard as individuals rather than as members of a family unit;
    (iii) give rise to an *increased* liability to tax for very many families – notably where the taxable income of one of the parties to a marriage is nil, or insufficient to absorb his or her personal allowances.
(b) *Secondly,* we might adopt a system of separate taxation by voluntary election. However, that

138. I cannot regard separate taxation as suitable for this community. Whether mandatory or by way of election, it would be expensive. Updated estimates suggest that in the year of implementation the cost could be as much as $285 million in lost salaries tax and personal tax and perhaps $180 million in a full year. On grounds of cost alone, therefore, separate taxation is simply not possible. The burden would have to be transferred to others. Furthermore, though I am sympathetic to the women's cause, my sympathy must not be allowed to overshadow wider considerations. The adoption of a system of completely separate taxation for husbands and wives would represent a radical departure from our traditional concept of the family unit as the fiscal unit of charge. Hong Kong remains essentially a Chinese community where filial piety and family unity are an integral part of our existence. It would be unfortunate indeed if, in our endeavours to remove an alleged affront to one arguably small sector of our society, we succeeded in giving greater offence to the community at large.

139. Nonetheless I do believe that we can and should meet fair criticisms. This can be achieved by, on the one hand, removing the offensive deeming provisions in the Ordinance, and on the other by going some way down the alternative route of separate elected assessment.

140. Accordingly, I propose that later this year amending legislation should be introduced, which will –

firstly replace those provisions which deem the income of a wife to be that of her husband for the purposes of salaries tax and personal assessment, with new provisions which will require the aggregation of their incomes for the purposes of calculating total liability to tax;

secondly remove the provision which deems a wife to be one and the same person as her husband for the purposes of the profits tax (this will in fact do no more than regularise departmental practice, since profits tax returns submitted by wives who are proprietors of businesses are already accepted); and

thirdly continue to require the husband to render returns and to be primarily responsible for payment of salaries tax and personal tax, but provide that, following *an election* jointly made, husband and wife may render joint returns, each certifying the accuracy of their respective statements of income and the claims for allowance and expenses and each being responsible for the payment of his or her share of the total tax bill; each share being calculated by reference to their respective shares or the total income.

141. It will be apparent that these measures, if enacted, will meet the complaints that the present legislation is insulting to women in that it renders them second class citizens. This not surprisingly creates discord. They will therefore be accorded the legal personality which they seek. I am told that this has been a main preoccupation in seeking amendments to the Inland Revenue Ordinance. I hope that this is the case, because it will also be apparent that these proposals will not give rise to any tax savings in individual cases; and will thus happily involve no loss to revenue.

142. Nevertheless I believe that the changes proposed are not merely cosmetic. It will take time to prepare the necessary amending legislation and to devise new forms, procedures and computer programmes to deal with those who decide to make the election. I propose accordingly that the amending legislation shall take effect from 1st April 1984. If that seems some way off to those who have been pressing for change, I would ask them to exercise further patience in the knowledge that I have today conceded the principle. And I must sound one caveat. One of my trusted Chinese women advisers has warned me that the proposal to permit an election for joint returns and separate payment may not find favour in Chinese families. I therefore intend to observe the course of the subsequent debate; and only if there is a clear consensus in favour with no major objections will I introduce amending legislation with regard to election.

Marginal tax rates

143. Before leaving the subject to personal taxation I should like to mention the structure of the tax bands, which are applied to salaries and personal assessment. This issue was raised by Dr. Rayson Huang during last year's budget debate.[13]

144. It has been suggested that because the width of the bands themselves has not been changed for some considerable time, middle and lower income taxpayers are being pushed into higher tax brackets through the effects of inflation. Thus they suffer a reduction in after-tax take home pay and a loss of real purchasing power. I am satisfied, however, that this has not generally been the case. I do not want to prolong this speech on technical taxation matters. A full explanation is thus annexed to the printed version.[14]

INTEREST TAX

145. I have been carefully monitoring the effects of the interest tax reliefs introduced in the last budget and about which Dr. Hu has spoken. The exemption of foreign currency deposits from interest tax has clearly been successful in enhancing Hong Kong's position as an international financial centre, but not without side effects. The value of Hong Kong dollar denominated time, call and notice deposits with banks and dtc's has declined from about $73 billion at the end of February 1982 to $59 billion at the end of December 1982, but savings deposits, which are not subject to tax, have increased from $48.3 billion to $61.9 billion. Over the same period total Hong Kong dollar deposits increased marginally from $134.4 billion to $135.4 billion. These figures can be read as indicating that the retention of an interest tax charge, albeit lower than before, has restrained the growth of Hong Kong dollar deposits. But I am not yet persuaded that the benefits which would arise from a total removal of this tax would offset the loss of revenue that would be involved. The actual figure is $725 million in 1982–83, which may surprise you. For 1983–84 it is estimated that the abolition of this tax would result in a loss of revenue of about $620 million. This is clearly not a sum which can be foregone in present budgetary circumstances. I do not therefore intend to introduce any further changes for the time being.

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would be to give some taxpayers the best of all worlds. The system is not unknown elsewhere, but is generally to be found in territories where marginal tax rates are very high indeed, bordering on the confiscatory. Furthermore, most of the inequities inherent in a mandatory system would also be present in an elective system; the more so, in the sense that only those who would gain a tax saving advantage would elect.

(c) *Thirdly,* we might adopt a system of separate *assessment,* that is to say a system whereby either one of the parties to a marriage, or each separately, or the parties jointly made returns of taxable income, from which is computed liability to tax based on their aggregate income. Thereafter, payment of tax is effected either in one sum on the joint incomes or, usually by election, by each party separately in the proportion that their respective income bears to their aggregate total income.

(d) *Fourthly,* we might stay with our present system, which for the purposes of salaries tax and personal assessment deems the income of a wife to be that of her husband; and for the purposes of the profits tax deems the wife to be one and the same person as her husband. These deeming provisions in the Inland Revenue Ordinance seem archaic and offensive to women, implying that they are second-class citizens, subservient to their spouses.

13. These tax bands, which are contained in the Second Schedule to the Inland Revenue Ordinance, are set at $10,000 each and tax is charged on the first $40,000 of net chargeable income at rates of 5%, 10%, 15% and 20% for each $10,000 slice; thereafter, any balance of net chargeable income bears tax at the maximum rate of 25%. There is, however, an overriding provision that in no case is tax to be charged at more than the standard rate of 15% on total assessable income (less deductible outgoings and expenses, but without benefit of personal allowances). The Schedule was last amended with effect from the year of assessment 1978–79 when the previous maximum rate of 30% was removed.

14. Appendix C.

[Appendix C - next page]

APPENDIX C

TAX BANDS

A comparison of the position in 1982–83 with that of five years ago (1977–78, the year before the removal of the 30% maximum tax rates) shows –

firstly that the single personal allowance (plus additional personal allowance) has increased from $12,500 to the present level of $28,000, and the personal allowance for married couples has increased from $25,000 to $56,000 – that is to say, increases in basic allowances of 124%;

secondly that the allowance for the first child has increased from $4,000 to 8,000, and the allowance for the second child has increased from $3,000 to $5,500 – that is to say, increases of 100% and 83% respectively; and allowances for the third to ninth children have also increased significantly; and

thirdly that the dependent parent allowance, reintroduced in 1978–79 at $4,000 per dependent parent (no such allowance was available in 1977–78) has been successively increased to $8,000 for each such dependent parent.

2. All this means that tax thresholds have been raised by a very considerable extent. For example, a married couple who would have entered the tax net on a joint income of $25,001 in 1977–78 do not now enter the tax net until their joint income exceeds $56,000; a married couple with two children who would have become liable to tax in 1977–78 on an income in excess of $32,000 are now exempt until the total income is in excess of $69,500; and a married couple with two children and two dependent parents who became liable in 1977–78 on income in excess of $32,000 are today exempt unless their income exceeds $85,500 – an increase in the tax threshold of no less than 167%.

3. Given these very significant increases in the levels at which persons become liable to pay tax, levels which in themselves are far in excess of the year on year rate of increase in consumer prices over the past five years, it can be seen that not only have the tax exempt been more fully protected from the effect of inflation on their liability to tax but, at the same time, the great majority of those within the tax net have also been protected in that these increased allowances have had the effect of deferring entry into the higher tax brackets.

4. The effects of inflationary fiscal drag have thus generally been negated and across the entire income spectrum, even those whose increments to taxable income have done no more than keep pace with inflation are in general no worse off today than they were five years ago in terms of net (after tax) take home pay and real purchasing power. In fact, Inland Revenue Department statistics of those liable to salaries tax show that the average per capita increase in taxable incomes during the same five-year period has been of the order of 20% per annum.

Conference Diary

JULY 1983

Asian-Pacific Tax & Investment Research Centre (APTIRC): Tax Planning, Tax Avoidance and Tax Evasion (including: tax avoidance in the United Kingdom; tax avoidance and evasion – developments in Australia; tax planning in South East Asia – tax avoidance measures; royalties and withholding taxes in Malaysia, and the impact of contractors tax imposed by Section 107A of the Income Tax Act; corporate laws in South East Asian countries vis-à-vis foreign investment and transfer of technology; investment in Sri Lanka by South East Asian countries and investment by Sri Lankan companies in South East Asia; how the tax authorities in Europe are combating avoidance tactics; the role of fiscal incentives in capital formation in developing countries; Indian investment in South East Asia and vice-versa; tax planning: the role of Hong Kong and the shape of taxation in the People's Republic of China; new individual taxation system in the Philippines; Indonesian withholding tax on interest, dividends and royalties). Singapore (Republic of Singapore), July 19-20 (English).

SEPTEMBER 1983

Management Centre Europe: Franchising (including: franchising abroad – money and taxation). Brussels (Belgium), September 22 and 23 (English).

Dr. Peter Deubner Verlag GmbH: Tax beneficial investment X (Steuerbegünstigte Kapitalanlagen X) (Seminar). Munich, Frankfurt, Cologne (Federal Republic of Germany), September 28-30 (German).

OCTOBER 1983

British Branch I.F.A.: U.S./U.K. Seminar. London (United Kingdom), October 6-7 (English).

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 9-14 (English, French, German, Spanish).

SEPTEMBER 1984

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). September 16-21 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Asian-Pacific Tax & Investment Research Centre: 2, Nassim Road, Singapore 1025, tel. 235-1959. Telex rs 50257 aptirc (Republic of Singapore).

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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).

Dr. Peter Deubner Verlag GmbH, Abteilung Seminar, Postfach 410268, 5000 Köln 41 (Federal Republic of Germany).

The 1983 Income Tax Changes in the Republic of South Africa

by Dr. Erwin Spiro

According to the Minister of Finance, Prof. Owen Horwood, who presented the 1983 Budget on 30 March 1983, that Budget is clearly conservative in character, its central theme remaining that of reasonable financial discipline, not as an end in itself, but as a means to the achievement in the medium and long term of sound and rapid growth on the basis of stability. The income tax has not been increased, but higher salaries and interest rates – as the result of inflation – bring the taxpayer automatically into a higher bracket (so-called fiscal drag), and the easter egg of the abolition of the 5% loan levy to private individuals is but a small consolation.

I. STRUCTURAL INCOME TAX REFORMS

Fringe benefits

The Parliamentary Committee plans to complete its report very shortly. It is not envisaged that any decisions that may be made can be implemented before 1 March 1984.

Initial and investment allowances

The Standing Commission on Taxation Policy recommended in a recent Report that the investment allowance – because of its high cost to the Exchequer, its very limited role as an anti-cyclical instrument, its doubtful efficacy (save in marginal cases) as an incentive to investment and its exposure to abuse – should be discontinued and that an extension of accelerated depreciation through initial allowances be considered in its stead. The Minister accordingly proposed that:

(a) the 30% investment allowance in respect of machinery and plant which expires on 30 June 1985 and the 20% investment allowance in respect of buildings which expires on 30 June 1986, not be renewed;

(b) in the case of machinery and plant used in a manufacturing process and brought into use on or after 1 July 1985, the 20% initial allowance be increased by 55%; and

(c) in the case of a building in which a manufacturing process is carried on and which is brought into use on or after 1 July 1986, an initial allowance of 20% of the cost be granted.

As a result, the total of the various allowances under the Income Tax Act in respect of machinery, plant or buildings will not exceed 100% of their cost. The proposals do not, however, apply to processes regarded as similar to manufacturing.

Building society shares

The present system of allowing building societies to offer investors "tax-free indefinite period" shares and "subscription" shares, together with the favourable treatment of dividends on their ordinary shares, entailing a loss of revenue to the State approaching perhaps 100 million rand per year, will gradually be phased out. Instead, the State intends to pay a direct interest rate subsidy to mortgagors who have bonds with building societies and other approved financial institutions below specified amounts, but subject to certain restrictions on, for example, the income of the home-owner and property values.

Taxation of blacks

Agreement has now been reached with all the national states, and as from the tax year commencing on 1 March 1984, all taxpayers in South Africa will be taxed on the basis of the Income Tax Act (Act 58 of 1962), as amended. The national states will retain their right to tax their citizens and, while Inland Revenue will collect the tax in areas outside the boundaries of the national states, each state will collect the tax from its citizens within its boundaries. As payments of taxes cannot be identified on ethnic lines, especially PAYE deductions, and, since the yield to the national states of taxes collected under the Income Tax Act will be less than under the Black Act, a basis of payment to the national states will be proposed to ensure that they are not worse off from 1 March 1984 than under the existing dispensation and that payments to them are increased annually at a rate equal to the increase in the total income tax collected from individuals in the Republic of South Africa outside the national states.

II. INCOME TAX CONCESSIONS

Farming

The Minister paid attention first of all to those farmers who were forced to liquidate part of their livestock and who would be taxable on the proceeds, but who would need to reacquire stock as soon as grazing conditions improved. The Minister proposed an amendment of the Income Tax Act, effective retrospectively to years of assessment commencing on or after 1 March 1982, to allow the proceeds of such forced liquidation of livestock to remain untaxed while deposited with the Land and Agricultural Bank, but on condition that these proceeds be reinvested in new livestock within 4 years after the year of the forced sale, such concession only being applicable when the income tax returns are submitted at the end of a tax year and will, therefore, result in minimal loss of revenue in the coming financial year.

Retirement benefits

The following concessions are proposed to be granted with effect from the tax year which commences on 1 March 1983:

(a) *Contributions to retirement annuity funds:* These contributions do not presently qualify for deduction from a person's income unless he carries on a trade, and, where he does, the contributions cannot be deducted from investment income (such as dividends or interest) or income in the form of annuities or pensions. Retirement annuity funds originally came into being as a form of pension fund for the self-employed. They are also used by salary earners to augment their pensions from pension funds. Such contributions are now to be allowed as deduction against investment income, annuities or pension receipts.

(b) *Lump sum benefits on retirement:* In calculating the exempt portion of lump sum benefits from pension and provident funds in accordance with the formula prescribed in the Act, so much of the member's average annual salary during a particular period as does not exceed 30,000 R is taken into account. The maximum exemption in respect of such benefits and lump sum benefits from retirement annuity funds amounts to 60,000 R. Having regard to the substantial remuneration adjustments in the past few years, the amount of 30,000 R is proposed to be increased to 40,000 R and the amount of 60,000 R to the greater of 80,000 R or an amount calculated by multiplying the amount of 3,000 R by the number of years in the member's period of service (where he is a member of a pension or provident fund) or the number of years in the period during which he was a member of a retirement annuity fund.

(c) *Service bonuses on retirement:* In terms of the present provisions of the Income Tax Act, so much of a bonus given by an employer to his employee on the termination (or, in certain circumstances, impending termination) of his services as does not exceed 20,000 R is exempt from tax. This amount is proposed to be increased to 30,000 R.

The aged

The Minister proposed that the additional tax rebate for persons over the age of 70 years should be increased from 80 R to 180 R This rebate, together with the 120 R rebate for persons over 60 (which persons over 70 also enjoy), will thus in total increase from 200 R to 300 R.

Post Office Savings Bank Certificates

The Minister's proposals in regard to Post Office Savings Bank Certicates are that:

(a) the general exemption limit per taxpayer be increased to 40,000 R with effect from the 1983 year of assessment; and
(b) in the case of investments not exceeding 60,000 R which were made by a taxpayer prior to 1 March 1982, the amount of interest which will be exempted in the 1983 or 1984 tax year be increased to the amount of interest which would have been exempt in terms of the exemption provisions as they were in force in the 1982 tax year.

Loan levy

(a) *Final deduction system:* As a result of the introduction of the new final deduction system in terms of which income tax returns are no longer required from salary earners in the lower income groups (those below 7,000 R), the names of more than 340,000 persons are in the process of being removed from the income tax register. This means that with the passage of time the addresses of many taxpayers will no longer be known to Inland Revenue. Many of them paid loan levies in earlier years (1978, 1979 and 1980) and will have to receive refunds in due course. In most cases the amounts are not large, and to obviate unnecessary administrative problems the Commissioner for Inland Revenue is to be authorized to refund such loan levies to these persons as soon as is practicable.

(b) *5% loan levy:* In view of the economy being in recession the Minister felt it desirable to inject a modest morale booster by way of financial relief, the best method to achieve this being to abolish the loan levy on personal income taxpayers which was re-imposed just a year ago.

Donations tax

The amount of 2,000 R up to which casual donations were not subject to donations tax has now been proposed to be increased to 5,000 R. The exemption in respect of donations in favour of the donor's children has likewise been proposed to be raised on donations effected after 31 March 1983 from 15,000 R to 20,000 R per child.

III. RATES OF (NORMAL) INCOME TAX

Persons other than companies

Persons other than companies are, in respect of the taxable income derived in the year of assessment ending 29 February 1984 or 30 June 1984, whichever is applicable, subject to (normal) income tax at the rates contained in the table attached, with a maximum basic marginal rate of 50% and with the *addition, in the case of unmarried persons, of a 20% surcharge on the tax.* The maximum rate of 50% is thus reached in the case of married persons where the taxable income exceeds 40,000 R and *in the case of unmarried persons where the taxable income exceeds 28,000 R.*

Companies

Companies are, in respect of taxable income derived in respect of every year of assessment ending during the 12-month period ending on 31 March 1984, subject to the following rates of (normal) income tax:

(i) on each rand of taxable income (excluding taxable income derived from mining operations and taxable income referred to in (ii)(c)), 42 cents plus a surcharge equal to 10% of the tax;

(ii) in respect of taxable income derived from gold mining:

(a) in the case of 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 15% of the said amount;

(b) in the case of post-1966 gold mines, an amount determined in accordance with one of the formulae laid down plus a surcharge of 15% 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 averge rate of tax as determined in accordance with the Act or 35 cents per rand, whichever is higher;

(iii) in the case of companies mining for diamonds, 45 cents per rand of taxable income plus a surcharge of 15% of such amount;

(iv) in the case of companies mining, but not for gold or diamonds, the position is the same as in the case of a non-mining company (see (i) above).

Taxpayers carrying on long-term insurance business

The taxable income derived from the carrying on of long-term insurance business in the Republic (whether on mutual principles or otherwise) is deemed to be an amount equivalent to 40% of the gross income derived from investments.

IV. RATES OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

Non-resident shareholders' tax

The non-resident shareholders' tax is 15% of the amount of the dividend or interim dividend in question.

Undistributed profits tax

The undistributed profits tax is 33⅓ cents on every rand 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% on the amount of the interest in question.

Donations tax

The donations tax is at progressive block rates, the block exceeding 90,000 R being taxable at the rate of 25%.

Income tax table referred to in III. above for persons other than companies

Taxable income (rands)	Rates of tax (rands + percentage on excess over lower amount)
below 7,000	10%
7,000 – 8,000	700 plus 12%
8,000 – 9,000	820 plus 14%
9,000 – 10,000	960 plus 16%
10,000 – 11,000	1,120 plus 18%
11,000 – 12,000	1,300 plus 20%
12,000 – 13,000	1,500 plus 22%
13,000 – 14,000	1,720 plus 24%
14,000 – 15,000	1,960 plus 26%
15,000 – 16,000	2,220 plus 28%
16,000 – 18,000	2,500 plus 30%
18,000 – 20,000	3,100 plus 32%
20,000 – 22,000	3,740 plus 34%
22,000 – 24,000	4,420 plus 36%
24,000 – 26,000	5,140 plus 38%
26,000 – 28,000	5,900 plus 40%
28,000 – 30,000	6,700 plus 42%
30,000 – 32,000	7,540 plus 44%
32,000 – 34,000	8,420 plus 46%
34,000 – 36,000	9,340 plus 47%
36,000 – 38,000	10,280 plus 48%
38,000 – 40,000	11,240 plus 49%
over 40,000	12,220 plus 50%

SOUTH AFRICA:

Budget 1983

Extracts from the Budget Speech pronounced by Mr. Owen Horwood, Minister of Finance, on 30 March 1983.

TAX PROPOSALS

Concessions

Customs and excise

Having already reduced the surcharge on imports by two successive amounts of 2,5% since December last year. I do not propose to make any further adjustments at this stage. However, in terms of the agreement with the International Monetary Fund, I am expected to phase-out the balance of this surcharge (5%) by the end of this year.

The Tobacco Board has submitted well-founded arguments for the maintenance of the status quo so far as duties on tobacco are concerned, and I propose to "let sleeping dogs lie"!

Sections of the liquor industry in the Western Cape have been experiencing financial problems for some time and that is one of the reasons why I do not purpose to raise excise duties on wine and spirits. So as not to disrupt the relative competitive position of the beer industry. I also do not propose to raise the duty on beer.

The Board of Trade and Industries has, however, received representations for an increase of the rebate on wine spirits entered for use in the manufacture of brandy and has already informally recommended that the extent of the rebate be increased from 7,123c per 100 litres absolute alcohol to 8,844c per 100 litres absolute alcohol.

I am in favour of the recommendation and as soon as the formal proposal is received from the Board, a Government Notice to give effect to it will be promulgated in the Government Gazette.

The loss in revenue is estimated at R 3 million.

Farming

The drought conditions and the various relief measures instituted by the Government have been dealt with in detail in the document which I will table today, but there is an income tax concession which I would like to announce in respect of those farmers who are being forced to liquidate part of their livestock and who would be taxable on the proceeds but who would need to reacquire stock as soon as grazing conditions improved.

In order to accommodate such farmers I wish to propose an amendment to the Inland Tax Act, effective retrospectively to the years of assessment commencing on or after 1 March 1982, to allow the proceeds of such forced liquidation of livestock to remain untaxed while deposited with the Land and Agricultural Bank, but on condition that these proceeds be reinvested in new livestock within four years after the year of forced sale.

This concession can only be applied when the income tax returns of such farmers are submitted at the end of a tax year and will therefore result in minimal loss of revenue in the coming financial year.

Retirement benefits

The various provisions of the Income Tax Act which encourage people to make adequate provision for retirement need to be regularly reviewed. I therefore propose that the following concessions be granted with effect from the tax year which commences on 1 March 1983:

(a) *Contributions to retirement annuity funds:*
These contributions currently do not qualify for deduction from a person's income unless he carries on a trade, and where he does, the contributions cannot be deducted from investment income (such as dividends or interest) or income in the form of annuities or pensions. Retirement annuity funds originally came into being as a form of pension fund for the self-employed. They are also used by salary earners to augment their pensions from pension funds. I feel that everyone, including pensioners, should be encouraged to make further provisions to supplement their income, and hence I wish to propose that such contributions now be allowed as deductions against investment income, annuities or pension receipts.

(b) *Lump sum benefits on retirement:*
In calculating the exempt portion of lump sum benefits from pension and provident funds in accordance with the formula prescribed in the Act, so much of the member's average annual salary during a particular period as does not exceed R 30,000 is taken into account. The maximum exception in respect of such benefits and lump sum benefits from retirement annuity funds amounts to R 60,000. Having regard to the substantial remuneration adjustments in the past few years, I propose that the amount of R 30,000 be increased to R 40,000 and that the amount of R 60,000 be increased to the greater of R 80,000 or an amount calculated by multiplying the amount of R 30,000 by the number of years in the member's period of service (where he is a member of a pension or provident fund) or the number of years in the period during which he was a member of a retirement annuity fund.

(c) *Service bonuses on retirement:*
In terms of the current provisions of the Income Tax Act, so much of a bonus given by an employer to his employee on the termination (or, in certain circumstances, impending termination) of his services as does not exceed R 20,000 is exempt from tax. I propose that this amount be increased to R 30,000.

The loss of revenue as a result of these concessions is estimated at R 7 million in the 1983-84 financial year and R 15 million for a full year.

The aged

The persons who will benefit most from the concessions in respect of retirement benefits are those who have not yet retired. The position of persons who retired some time ago and whose ability to augment their income is thus reduced, has also received my attention. They are often in a weaker position than others as a result of the gradual decline in the value of their fixed incomes, and I therefore propose that the additional tax rebate for persons over the age of 70 be increased from R 80 to R 180.

In practical terms, this rebate together with the R 120 rebate for persons over 60 (which persons over 70 also enjoy) will thus in total increase from R 200 to 300.

The loss of revenue is estimated at R 3 million for the 1983-84 financial year and R 4.5 million for a full year.

Donations tax

Donations tax was originally introduced to counter the avoidance of income tax as well as estate duty by means of donations. Casual donations as a "small value" cannot be labelled as tax avoidance and an exemption has thus been provided in respect of such donations which do not exceed R 2,000. The concept of "small value" is relative in the times we live in and I propose that the amount of R 2,000 be increased to R 5,000.

By reasons of increased values, I wish to propose that for donations tax purposes the exemption in respect of donations in favour of the donor's children, on donations effected after 1 March 1983 be raised from R 15,000 to R 20,000 per child.

The loss of revenue as a result of these concessions is estimated at R 100,000 per annum.

Post Office Savings Bank Certificates

Up to and including the 1982 year of assessment an exemption from income tax was allowed in respect of the interest received by each person from an investment in Post Office Savings Bank Certificates not exceeding R 10,000. Last year the Income Tax Act was amended to the effect that, as from the 1983 year of assessment, the exemption will be applicable to the interest derived by a taxpayer on an investment not exceeding R 20,000.

This change still leaves the Post Office in a less favourable position in regard to the amount which can be invested with it free of tax.

Although change still leaves the Post Office in a less favourable position in regard to the amounts which can be invested with if free of tax.

Although the exemption, as updated last year, was sufficient where a man and his wife both had investments in Post Office Savings Bank Certificates, a number of persons had made investments on behalf of their minor children which, at the time when the investments were made, would have been totally exempt from tax to a maximum amount of R 10,000 per child. I feel that in these cases the exemption should be phased-out over a period of two years to afford the persons concerned the opportunity to make other arrangements.

I propose therefore that:

(a) the general exemption limit per taxpayer be increased to R 40,000 with effect from the 1983 year of assessment; and

(b) in the case of investments not exceeding R 60,000 which were made by a taxpayer prior to 1 March 1982 the amount of interest which will be exempted in the 1983 or 1984 tax year, be increased to the amount of interest which would have been exempt in terms of the exemption provisions as they were in force in the 1982 tax year.

The loss of revenue is estimated at R 900,000 for 1983-84 and R 3 million for a full year.

The *aggregate of the concessions* thus far proposed will amount to R 14 million in 1983-84.

I should like next to deal with the two tax measures involving higher imposts.

Additional tax measures

Advertising and publicity services

The general sales tax on advertising and publicity services which I proposed last year was to have come into operation on a date to be determined by me to allow adequate consultation between the Commissioner and interested parties.

From the discussions it emerged, however, that the greatest single stumbling block was the adaptation, at short notice, of existing advertising and promotion budgets to allow for general sales tax payments by those concerned.

I have therefore decided that the date for coming into operation be determined as 1 January 1984. This will afford advertisers adequate opportunity to adapt their budgets and absorb such expenditures.

Expected proceeds in the 1983-84 year will be R 5 million, while in a full year this total could reach R 30 million.

Stamp duties

It will be seen from the Estimates of revenue collections that stamp duties form an important part of indirect taxation. Viewed individually, the various stamp duty items may seem unimportant. In fact, from time to time suggestions are made for the abolition of particular items which in the course of time have lost their significance. Such duties have in fact mostly been deleted already.

On the other hand, with the passage of time some items which used to yield appreciable amounts of revenue have, because of inflationary and other factors, lost some of their vitality as revenue earners. This is particularly true in those cases where fixed amounts of duty are payable.

The various dutiable documents have been examined and in most cases is has been found that stamp duties have remained unchanged for some considerable time – some for as long as 15 years and in one case for as long as 72 years! – and that yield can be increased without causing the rates to become unduly burdensome.

My proposals in this regard cover increased duties on agreements, antenuptial and postnuptial contracts, bills of exchange, customs and excise documents, duplicating originals, fixed deposit receipts, credit agreements, partnership agreements, insurance policies, powers of attorney and security of suretyship. Full details appear in the taxation proposals I shall table today.

The yield is estimated to amount to R 20 million for 1983-84.

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Loan levy

It is with the loan levy on individuals that I feel some meaningful relief can most appropriately be offered to taxpayers. Here I wish to announce two concessions:

(a) *Final deduction system:*
As a result of the introduction of the new "final deduction system" in terms of which income tax returns are no longer required from salary earners in the lower income groups (those below R 7,000), the names of more than 340,000 persons are in the process of being removed from the income tax register.

This means that with the passage of time the addresses of many taxpayers will no longer be known to Inland Revenue. Many of them paid loan levies in earlier years (1978, 1979 and 1980) and will have to receive refunds in due course. In most cases the amounts are not large, and to obviate unnecessary administrative problems I propose that the Commissioner be authorized to refund such loan levies to these persons as soon as is practicable.

The estimated amount involved, already allowed for in loan redemptions, is R 15m, while interest payments amounting to approximately R 3.8m have already been allowed for in the statutory provisions for public debt interest.

(b) *5% loan levy:*
Where the economy is in recession I feel it desirable to inject a modest moral booster by way of financial relief, and the best measure to achieve this is in my view to abolish the loan levy on personal income taxpayers which I had re-imposed just a year ago. This will leave the maximum marginal rate of tax at 50% without any loan levy encumbrance.

I propose therefore to abolish the loan levy on individuals with effect from the tax years commencing after 1 March 1983.

The amount foregone to the Exchequer is estimated at R 230m.

On this basis, the 1983-84 Budget is exactly balanced.

In next issues:

Capital taxation in the individual income tax: a Brazilian perspective
– by *Carlos A. Longo*

The tax system of Tahiti (French Polynesia)
– by *Eugen Jehle*

Papua New Guinea 1983 Budget: Income tax amendments
– by *Stewart Naunton*

United States: A foreign tax under new proposed foreign credit regulations
– by *Edward H. Lieberman*

The MIRAS touch: Private sector involvement in tax administration
– by *H.W.T. Pepper*

Sri Lanka: Budget 1983
– by *M.P. Dominic*

The abolition of turnover tax borders in the EEC: A step in two directions
– by *Mary Loughran*

Zambia's 1983 Budget
– by *A.B.C. Emmanuel*

AUSTRALIA:

Unfinished taxation business

Statement made on 30 March 1983 by the Minister for Finance, the Hon. J.S. Dawkins, M.P. on unfinished taxation business of the former Government.

At the time of the change of Government sixteen taxation measures announced by the former Government had not been carried into legislation.

Some of the measures were announced as long ago as December 1981. Some had revenue implications for 1982–83; all had revenue implications for 1983–84 which had been built into the forward estimates of receipts. In many cases businesses had assumed the operations of the measures in their accounting and planning procedures.

Some of the measures had been taken part way through the Parliament prior to the dissolution but in relation to others the drafting of bills was less advanced.

What confronted the new Government was a legislative shambles which revealed the total disorganisation of the decision making processes of the former Government and the former Treasurer.

Had the former Government been less interested in manipulating a favourable political climate and more dedicated to the business of governing the country all these measures would now be on the statute books.

The Government has moved quickly to determine the future of these measures and to assign a legislative priority to them.

The Government has decided that legislation covering nine of the measures will be ready for the May sittings, legislation covering four of the measures will proceed in the Budget sittings and the Government has decided not to proceed with three of the measures. Except where otherwise indicated, the Government has it in mind to adopt the detailed features of the proposals as they were announced by the former Government.

In making its decision the Government was conscious of the very difficult budgetary situation it has inherited and this grim reality restricted greatly the options for reviewing the measures.

Legislation will be introduced in the May sittings to give effect to the following announced measures:

Payments for labour and services

This measure announced in the last budget is essential to the Government's crack down on tax avoidance and evasion. It involves no new taxes but rather new procedures to ensure that tax which is legally payable is collected.

These new procedures will apply initially, as had been decided but not announced by the previous Government, to payments in industries identified by investigations and audits carried out by the Taxation Office as those in which the most significant evasion is occurring, with compliance rates of as low as 55 to 60%. Those industries are the building construction and associated industries – architectural, consultant engineering, surveying and other technical building services and joinery and cabinet making – and in the road transport, motor vehicle repair and cleaning industries. They will increase collections by $300 million next year and, when extended to cover payments in all industries, by up to $500 million in a full year, it being planned to effect further extensions over the next 12 months.

Regrettably the administrative and decision making hiatus caused by the election has meant that, in order to allow time for those who will be affected to incorporate the necessary procedures in their organisations, the new procedures foreshadowed for 1 July will not be in place until 1 September.

The new procedures involve the collection of tax at the time the labour or services are paid for and will require businesses and other organisations to deduct specified amounts from payments made in relation to labour or services provided, and forward the tax collected to the Taxation Office.

The main features of the system were set out in the information paper issued by the former Treasurer on Budget night and final details of the scheme will be settled following discussion with industry representatives. However, the Government is determined to ensure that householders are not required to make deductions in relation to services provided, other than by employees as such.

The Government is of the view that the menace of tax evasion will only be eliminated if the community is prepared to co-operate, and so some limited new reporting requirements will be introduced to guarantee the success of these new arrangements. Unless tax is collected from everyone who has an obligation to pay, then the burden will fall disproportionately on those decent law abiding Australians who have regularly been paying their taxes.

Accelerated depreciation

The legislation will introduce a new system of plant depreciation allowances under which plant is generally to be depreciated on a prime cost basis over either five or three years, including a write-off over three years of plant used in primary production. However, the Government has decided that works of art should not qualify for the accelerated rate. We are also considering the extent to which plant that comes under new ownership by virtue of bank mergers and re-organisations of business operations should qualify.

As previously announced, the new system will apply with respect to plant acquired under a contract entered into after 19 July 1982. Normal safeguards against the rearrangement of contracts to secure the benefits of the new system for plant originally contracted for before 20 July 1982 will apply. In addition, the Government has decided to act to prevent arrangements involving the sale and leaseback of plant originally acquired by the lessee prior to 20 July 1982 from having the effect of securing for that plant the benefits of the accelerated system. For this purpose the pre 5/3 depreciation rules will continue to apply to sale and leasebacks and similar arrangements where the real end-user would have otherwise been depreciating the plant under the pre 5/3 rules.

Depreciation of non-residential buildings

Under this proposal depreciation allowances will be available for new non-residential income producing buildings. This measure applies where construction of such a building commenced after 19 July 1982.

Mining allowable capital expenditure

A new basis of deduction is to be introduced for capital expenditure incurred in developing a mining property or oil field, under which deductions will generally be available on a straight line basis over ten years. The new basis of deduction generally applies to development expenditure incurred after 19 July 1982.

Payment of interest on overpaid tax in objection cases

Interest is to be paid under this proposal where overpaid tax is refunded to taxpayers following the introduction of legislation increasing from 10% to 20% the rate of penalty for late payment of income tax which has effect from 14 February 1983.

Concessions for investment in Australian films

It is proposed to broaden the scheme of tax incentives for the Australian film industry to permit a tax deduction to be taken in the year a qualifying investment is made. The revised basis of deduction will apply with respect to expenditure incurred by an investor under a contract entered into on or after 13 January 1983.

Collection of tax payable by non-residents

This proposal will strengthen provisions in the Income Tax Assessment Act governing the collection of tax payable by non-residents.

Australian shipping industry measures

Subject to the successful conclusion of negotiations currently being conducted by the Minister for Transport, we will adopt the proposal to provide for accelerated depreciation of trading ships over five years together with an extension of the investment allowance to Australian ships trading overseas.

It has also been decided that the following proposals of the previous Government will be given effect in legislation to be introduced in the Budget sittings:

Leveraged leasing and similar arrangements

With effect from 19 December 1981, there will be legislation to counter arrangements designed to defeat the policy of the income tax law that the investment allowance is not available where the end-user of the plant in question is a tax-exempt body and, with effect from 1 pm on 24 June 1982, to deny to equity participants in leveraged leasing and similar arrangements the deductions attributable to ownership of the plant (including depreciation, interest and investment allowance) in cases involving the use of overseas plant by non-residents or existing plant already in use with the lessee or end-user or where the plant is leased or in real end-use in tax-exempt activities.

Bonuses and other amounts paid on short-term policies of life insurance

Under this heading it is intended to remove, in respect of short-term life insurance policies, the advantage in the present law under which bonuses and other amounts are received by policy-holders free of income tax.

Sales tax machinery and anti-avoidance measures

The machinery and liability provisions of the sales tax legislation are to be simplified and improved and will include some measures to counter tax avoidance practices and to increase the rate of penalty tax for late payment to 20%.

Double taxation agreements

The Government has also decided to complete all outstanding matters in the current work program for the conclusion of double taxation agreements with other countries.

However, the Government has decided *not* to proceed with the following 3 policy initiatives of the previous Government, two of which were announced in the 1982/83 Budget and which are to be deferred for later review:

Transfer of losses within company groups

This proposal would have allowed company groups to offset a loss suffered by one company in the group against the taxable income of another company in the group. The Government wishes to investigate further the revenue and other implications of this measure. For example, first year cost estimates vary from $100 to $200 million.

Employee share acquisition schemes

Under this heading it was proposed to exempt from income tax certain benefits to employees under approved employee share acquisition schemes. The Government proposes in relation to this matter, which is put forward as being for the benefit of employees, to enter into discussions with the ACTU.

Sales tax on retreaded tyres

The Government has also decided not to override by legislation the decision of the Commissioner of Taxation that for sales tax purposes tyre-retreading constitutes manufacture. (The Commissioner has advised that his decision will apply from 1 June 1983.)

APTIRC STARTS NEW BULLETIN

The newly established Asian-Pacific Tax & Investment Research Centre, at 2 Nassim Road, Singapore 1025, has started its operations as from 1 April 1983. Preparations for release of its *Asian-Pacific Tax & Investment Bulletin* are in an advanced stage. The first issue of the *Bulletin* will be published by early July 1983. The *Bulletin* will present objective studies on taxation, investment, trade, banking and related matters, primarily with regard to the Asia-Pacific Region, and is meant to meet the requirements of governments and the business and professional community.

The major articles in the first issue of the *Bulletin* include:

- Fiscal Policy for Development in ESCAP Region
- International Transfer Pricing – An Australian Experience
- Philippines – Highlight of Batas Pambansa Blg. 391 – The Investment Incentive Policy Act of 1983
- Malaysia – Section 107A of the Income Tax Act, 1967 and the Revenue Rulings
- Concept of Permanent Establishment in Tax Treaties.

The *Bulletin* also contains summaries and extracts of 1983-84 budgets of the governments of Hong Kong, India and Sri Lanka; APTIRC Conference Diary; and bibliography of the APTIRC Library.

Annual subscription rate $ (Singapore) 72.-.
Free samples available on request.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. See also Erratum (p. 193 of the May 1983 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Deficiencies of Current Taxation of Capital Income

by Carlos A. Longo

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1. INTRODUCTION

National plans as a basic instrument for Brazilian economic policy were introduced in the mid-50s, became popular during the 1960s and early 1970s, and dwindled into oblivion with the oil crisis. The spirit of benign government intervention, however, was not abated. In fact, the 1964 constitutional reform practically transferred to the administration the exclusive right to legislate on tax issues, which has since been fully utilized to promote national and regional development goals, and less so, we argue, to collect revenues as equitably and efficiently as possible. It follows that target sectors or activities are heavily subsidized (exports, energy, agriculture, government enterprises, etc.) either through the tax system or directly through government credits, while traditional public services are in short supply (health, education, law and order, etc.).

Taxes as a percentage of GNP are stable, or declining somewhat, but the government share of the economy is increasing. The difference is made up by a higher public debt, deficits of central and local government, losses of government enterprises, and the growing number of government enterprises in areas otherwise provided for by budgetary expenditures or the private sector. The minor role attributed to the federal budget is reflected in the fact that even though it is essentially balanced, the inflation rate runs at approximately 100% a year, which results from the excessive use of government credit subsidies, with the Federal Reserve Bank (Banco Central) acting as a lender of last resort.

Before we continue, we assume that further reliance on this sort of government intervention is too costly and, short of major revisions in its current finance policy, the government sector will continue to increase to the point of complete exhaustion of the rest of the economy.

In this setting we look at a specific issue of tax reform: the taxation of capital under the personal income tax. Why capital and not labor? Because wages are reasonably well covered by the progressive rate structure. But why capital *under* the individual income tax? Because capital already contributes to a significant share of total income tax collection either through the corporation income tax or through taxes withheld at source. In the end, we conclude that the federal financial structure may be improved if conventional sources of revenue (i.e. taxes) are substituted for deficit financing and additional borrowing as a major source of revenue by bringing into the tax base capital income so far excluded or granted preferential treatment under the existing tax law.

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2. TAX STRUCTURE

In Brazil, the income tax basis is determined along with a legal definition of income. The tax law specifies items of income which are to be included in the tax base and those items, classified in schedules according to their nature, are added up before tax liabilities are computed.[1] Thus, schedular classification does not imply, a priori, discrimination of tax liabilities according to income source. Itemized deductions are allowed in each schedule for the cost of receiving income, and general deductions from total taxable income and tax credits are allowed to adjust income for ability to pay and to promote investment activities, respectively.

Table 1 indicates that capital income reported in the individual income tax return is minimal. In fact, labor income alone, grouped under Schedules C/D, accounts for 84% of total reported income. This follows, we argue, from two basic characteristics of the income tax law: lack of grossing-up requirements for interest and dividend income and capital gains, and the exclusion from the tax base of long term capital gains.[2]

The withholding tax procedure is quite general and applies to almost all income. Even though this is common practice everywhere, as a method of anticipating tax revenues, in Brazil progressivity in taxation of capital income may be avoided if the taxpayer chooses to be taxed at source only. Interest income is taxed, essentially, at two rates: 10% of nominal income or 30% if the income has been adjusted for inflation.[3] Also, cash dividends are taxed at two rates, but for quite different reasons: 15% on dividends paid out by public corporations (of which the shares are quoted at the stock exchange) and 25% otherwise (i.e. distributed by closely held corporations).[4]

With few exceptions, not statistically significant, the taxpayer always has the option to remain taxed at source only. There are two reasons why a taxpayer, given the opportunity, will not report interest and dividend income in his individual tax return. Let us, for instance take the case of interest. Firstly, unless his marginal tax rate is below 30%, there is no incentive for him to do so, since by adding this income to income from all other sources, he will increase his tax liability. Since capital income is typically received by high bracket taxpayers, and most interest is, as a matter of fact, derived in the form of nominal income,[5] which is taxed at a 10% rate, it is unreasonable to expect taxpayers to gross them up. Secondly (and this applies to dividend income also), identification is not required whenever the taxpayer elects to be taxed at source only. Non-identified financial transactions have a long tradition in Brazil and this explains why tax reform proposals have so far not tried to tackle the delicate issue of "gross-up requirements", fearing that investments may otherwise be diverted to non-productive activities, such as gold, foreign currency, etc. However the case may be, non-identification reinforces in many ways tax avoidance in the current tax law. A taxpayer with partial or total income derived from the underground economy (latu sensu) does not incur tax penalties, at least with respect to non-identified sources of income. Furthermore, if the taxpayer's only source of income is "non-identified" capital income, he is all set with the Internal Revenue Service (Secretaria de Receita Federal)! In general, the taxpayer has an incentive to change the composition of his portfolio towards non-identified sources of income since this puts him in a lower tax bracket. Alternatively, he may face a "tax penalty" if he decides to switch his investments in the opposite direction. On the other hand, an income tax applied to non-identified financial transactions becomes an indirect tax and, in this sense, its actual burden is difficult to ascertain. Thus it should come as no surprise if taxpayers shift the burden of this indirect tax forward as a transaction cost to the borrower directly or to consumers indirectly through price increases. The distortions in relative prices and progressivity derived from this tax are all too obvious and need not deter us here. As a result of non-identification provisions, the composition of tax collections at source bears no resemblance to the corresponding figures from reported gross income in the individual income tax returns.

Table 1
Gross income by source, Brazil, 1980

	Percentage
Interest (Schedules A/B)	0.6
Wages and other labor income (Schedules C/D)	84.0
Rent and royalties (Schedule E)	5.0
Dividends (Schedule F)	0.6
Agriculture (Schedule G)	0.8
Capital gains (Schedule H)	0.5
Other (non-specific)	8.5
	100.0

Source: Ministerio Da Fazenda (MF)/Secretaria Da Receita Federal (SRF)/ Coordinação De Atividades Especiais.

Table 2 rearranges Table 1 so as to leave out the percentages of gross income derived from non-capital income and compares the outcomes with the composition of taxes collected at source on capital income. The result is a significant contrast between the withholding tax shares and the corresponding shares of reported gross income. Clearly a substantial percentage of interest and dividends paid out (50.6 and 23.5, respectively) is not reported as gross income in the individual tax returns (8.7 and 9.4, respectively). On the other hand, rent and roy-

1. Income Tax Code and Regulation, Decree 85,450, December 1980.
2. Similar concerns have been raised elsewhere. E. Steuerle, for instance, estimates that only 30% of total capital income is reported to the IRS. See his "Is Income from Capital Subject to Individual Income Taxation?", 10 *Public Finance Quarterly* 3 (1982), 283–303.
3. A 10% rate on a nominal return of 110% a year is equivalent to 110% effective tax on the real return, when inflation runs at 100% a year. These are actual and rough figures prevailing in Brazil, at the present time. Also, 83.1% of taxes collected on dividends and interest comes from the nominal income of savings deposits and financial bonds.
4. Dividends are real income since profits are fully adjusted for inflation at the corporation level, according to the law.
5. There are, in Brazil, two classes of bonds, or interest-bearing securities (debentures). One is adjusted for inflation (indexed according to official estimates released each month) and the other is not. "Nominal income", in the text, refers to the second class. In this case, even though the statutory rate of tax is 10%, the effective tax rate may be very much higher (see footnote 3). Also, with inflation, gross-ups of nominal income shift taxpayers to artificially higher tax brackets.

Table 2
Gross income and withholding tax, by source, Brazil, 1980

Percentage

	Gross income[a]	*Withholding tax[b]*
Interest	8.7	50.6
Rent and royalties	74.3	12.6
Dividends	9.4	23.5
Capital gains	7.6	13.3
	100.0	100.0

Sources: a. Table 1;
b. MF/SRF/DIPRO (Divisão de Desenvolvimento e Orientação do Processamento).

alty income, which are necessarily grossed-up, by law, have their relative share shifted from 12.6% in withholding taxes to 74.3% on reported gross income.[6]

In principle, capital gains, adjusted for inflation, are taxed as ordinary income under Schedule H.[7] However, as we shall see, exemptions and exclusions leave capital gains untaxed in many instances. The gains realized on the sale of financial assets (as opposed to real property) retained for more than 5 years are excluded from the tax base. Also, the gains realized on the sale of stocks and investment funds of public corporations[8] are tax exempt. Stock dividends are not deemed a realization of dividends and thus are not taxable under Schedule F, but may be included in Schedule H as capital gains if sold before 5 years *and* not issued by a public corporation. Otherwise, the sale of stock dividends is not taxed.

Capital gains adjusted for inflation, realized in the sale of immovable assets (if not realized in the pursuit of a trade or business, in which cases they are taxed under Schedule F), are taxed as ordinary income under Schedule H, with an exemption level of US$62,500.[9] However, the gains realized on the sale of real estate assets held for more than 20 years are excluded from the tax base. If the property is sold before 20 years have elapsed, taxable gains are reduced by 5% per year of the holding period. In any case, capital gains realized on the sale of real property or financial assets are subject to a 20% maximum tax rate; therefore, progressivity is quite limited in this source of income. Furthermore, gains accrued on real property as well as financial assets transferred by gift or death are not taxable, since a step-up basis applies, i.e. after transfer by donation or death the beneficiary may use the value of the asset at the moment of his acquisition to compute any capital gains derived.

Agricultural income, not strictly a capital return for small properties, may become so otherwise. The net income derived from agriculture, ranching, fishing, etc., as well as manufacturing certain produce, may under Brazilian tax law be reduced by up to 80% by investment deductions leaving only 20% to be taxed (immediate write-offs, in some cases over 100% of capital expenditure, broadly defined to include maintenance expenses, such as fertilizers, mowing, etc., as well as equipment, construction and animals), which severely undermines progressivity.

Additionally, 50% of the adjusted net income is excluded from the tax base in computing tax liabilities, so that progressive rates apply to only 10% of *net* agricultural income, if deductions are fully utilized. Agricultural income is also subject to a maximum tax rate equal to 15% of gross revenues.

3. A COUNTRY-BY-COUNTRY OVERVIEW

In this section we compare the Brazilian structure of capital income taxation with that in other countries. We recognize that the definition of capital income is elusive and thus comparative studies of this sort must, of necessity, be arbitrary. But if we wish to have a country-by-country overview of the statutes, simplifications have to be made. In this sense, we follow general practice and distinguish between ordinary income and capital gains. Furthermore, within the ordinary income category we distinguish among interest, rent and royalties, cash dividends and stock dividends; and within capital gains between gains realized on the sale of real property and financial assets, and gains accrued on transferred properties, by gift or death.

The effective tax rate on any source of income depends, of course, on the definition of tax base (coverage), exempted income levels, and activities, cost deduction policies, deferral of tax liabilities, as well as nominal tax rates, omitting the economic effects of tax incidence analysis. The purpose here is descriptive, and, in a sense, much more limited. We look at several tax statutes and produce sweeping generalizations as to whether different sources of capital income are or are not essentially covered by the federal income tax. We compare, therefore, the Brazilian tax structure with countries of diversified institutional backgrounds, and spatial set-ups: industrialized (United Kingdom, France and Germany), industrialized and continental in size (the United States), semi-industrialized and continental in size (Australia and Canada); and try to identify in these countries major advantages in the individual income tax law, which, in turn, lead us to examine them more carefully.[10]

We find that recurrent capital income (interest, rents and royalties, cash dividends) is included in the tax base as ordinary income everywhere, and therefore reasonably well covered by the central government's income tax in each country of the sample. Minor adjustments to this generalization may be made to take care of, for instance, exempt government bonds, but they are not likely to alter fundamentally the picture we will draw here. Less

6. We note that fully grossed-up income would not be enough to equalize these proportions since tax rates are different anyway. If rates were uniform across sources of income and gross-ups were fully observed, then the percentages of columns 1 and 2 in Table 2 would be the same for each source of income.
7. The Code does not use the word capital gains. Instead the term "profits" realized in the purchase and sale of assets is used as such. Note also that Schedule H is a catch-all for income realized but not classified elsewhere (in other Schedules) or explicitly exempt, such as windfall gains, lotteries, etc.
8. "Investment funds of public corporations" refer to investment funds whose assets constitute stocks of public (quoted at the stock exchange – publicly traded) corporations.
9. December 1980 exchange rate.
10. Major sources for this overview were: OECD Report, *The Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals* (Paris, 1979); and *World Tax Series* (Commerce Clearing House, Chicago), prepared by Harvard Law School.

clear, however, more complex, and not uniform across countries is the treatment of capital income derived by individuals through corporations.

Income from corporations may take, either jointly or exclusively, the form of cash dividends, stock dividends, and capital gains. Cash dividends, as pointed out, raise no special problems since they are generally treated as ordinary income. Stock dividends are also treated as ordinary income in Australia and Canada.[11] However, several other countries do not recognize stock dividends as a realization of income, and therefore exclude such dividends from the tax base temporarily on a carry-forward basis or indefinitely, depending on whether capital gains realized on the sale of stock are included in the tax base. In this sense, taxpayers enjoy capital gains treatment as well as deferral of tax liabilities on stock dividends in Brazil, the United States, and the United Kingdom, but in Germany this source of income is entirely excluded from the tax base.

As we move to capital gains with respect to land, the overall picture becomes blurred, since we must face head on the problem of the definition of capital gains.[12] If only for deferral of tax liabilities on accrued income, taxpayers will now prefer to convert ordinary income into capital gains due to the preferential tax treatment generally accorded to the latter. Legislators, with the aid of court decisions, have tried to minimize this conversion by submitting, whenever possible, capital income to ad hoc classification tests. Thus, the holding period of an asset helps to determine whether the ralized gain is derived from "speculative" activities (ordinary income) or not (capital gain); the number of transactions with similar assets helps to determine whether the realized gain is derived from trade or business (ordinary income) or not (capital gain), etc.[13]

Use of the holding period test to discriminate among taxable events is widespread, although not uniform, across countries. Thus, Australia and Germany exclude from the tax base the amount realized on long term capital gains, which is defined as gains realized on the sale proceeds of assets held for at least 1 year in Australia, and at least 6 months or 2 years for financial or real assets, respectively, in Germany. Otherwise, gains are taxed as ordinary income in these countries. Other countries, such as Brazil and France, use the holding period test to discriminate between short and long term gains but the borderline in these cases is not clear-cut.

In the United States, a 1-year holding period, or less, indicates that the realized capital gains on real and financial assets are treated as ordinary income. Otherwise 60% of the realized capital gains are excluded from the tax base.

The holding period is not an issue in Canada and England where gains obtained from the sale of any asset are considered to be capital gains, which are not taxed, however, as ordinary income. Realized capital gains are taxed separately from ordinary income in England at a 30% flat rate; and in Canada 50% of realized capital gains are excluded from the income tax base and the balance is taxed as ordinary income.

The last item of capital income taxation to be mentioned is gains accrued on transferred assets, by gift or death. This occasion is the last opportunity to include gains accrued on these properties in the income tax base, since they are not taxed at the individual level while not realized (appreciated stocks, real estate, etc.). Canada is the only country which fully incorporates gift and inheritances in the income tax base and taxes as realized capital gains, to the donor or the estate, the accrued gain on these transfers.[14] The United Kingdom recognizes the gain accrued in donated properties and taxes them as realized capital gains to the donor; and the United States allows a step-up basis for transfers at death and tax deferral on lifetime gifts on a carry-over basis to the donee. In general, however, a step-up basis prevails and gains "realized" on transferred properties by gift or death are not recognized as such and therefore are excluded permanently from the tax base. A sketchy overview of the foregoing considerations of the structure of capital income taxation is presented in Table 3.

Table 3
Capital income tax structure

Nature	*Ordinary income*			
Schedule	*A/B*	*E*	*F*	
Source	*Interest*	*Rents and royalties*	*Cash dividends*	*Stock dividends*
Australia	X	X	X	X
Brazil	X	X	X	Carry-over
Canada	X	X	X	X
France	X	X	X	Carry-over
Germany	X	X	X	Carry-over
United Kingdom	X	X	X	Carry-over
United States	X	X	X	Carry-over

Nature	*Capital gains*			
Schedule	*H*			
Source	*Sale of stocks*	*Sale of real estate*	*Gifts*	*Inheritance*
Australia				
Brazil	X	X		
Canada	X	X	X	X
France	X	X		
Germany				
United Kingdom	X	X	X	
United States	X	X	Carry-over	

X means included in the individual income tax base. However, exclusions, specific exemptions and high threshold levels may well wash out the potential base.

Source: See text.

11. Price Waterhouse, *Corporate Taxes, A Wordwide Summary*.
12. See, for instance, S. Surrey "Definitional Problems in Capital Gains Taxation", 69 *Harvard Law Review* 6 (April 1956), 985–1015.
13. See IFA Cahiers, *The Definition of Capital Gains in Various Countries*, Vol. 64a (Kluwer); other tests include the nature of disposition (e.g. gift v. sale), nature of asset (e.g. homestead v. property for sale).
14. A carry-over basis is allowed for inter-generational transfers in the agricultural sector.

4. OTHER FORMS OF CAPITAL TAXATION

A wider coverage to this comprehensive survey may be accomplished if we consider other forms of capital taxation as well – although briefly – such as the taxation of wealth and capital transfers (gifts and inheritances). In principle, it is a matter of indifference whether we tax the flow of capital income or its stock value, provided we know the rate of discount and we make the proper conversion of the tax rates. In this sense, an income tax is equivalent to a wealth tax (property tax) and a permanent income tax (life-cycle income tax) is equivalent to a capital transfer tax. Thus, either one of these taxes could be utilized to finance general government expenditures according to the ability-to-pay criterion. More often than not, however, income and wealth taxes are applied simultaneously, irrespective of equity and efficiency implications.

The overall structure of taxes on capital transfers and wealth maintains, by accident or not, in each country, a certain relation to its corresponding income tax structure. Thus, Canada, which adopts the most comprehensive income tax base, refrains from any tax on capital transfers and wealth. On the other hand, Germany, which adopts the narrowest income tax base, "offsets" it with taxes on both capital transfers and wealth. A simplified description of the latter taxes in Table 4 indicates that other countries also compensate for loss of revenue from less comprehensive taxation of the income stream with taxes on capital value, such as Australia, which does not tax capital gains but taxes capital transfers. The corresponding picture for Brazil, however, is asymmetrical, in the sense that this country has a narrow income tax base as well as a reduced tax rate and coverage on capital values.

Table 4
Taxes on capital transfers[a] and wealth rates
(in %)

Statutory tax on / Country	Gifts		Inheritance		Wealth	
	Real estate	*Financial assets*	*Real estate*	*Financial assets*	*Real estate*	*Financial assets*
Australia	3–28	3–28	3–28	3–28	–	–
Brazil	4	–	4	–	–	–
Canada	–	–	–	–	–	–
France	5–20	5–20	5–20	5–20	–	–
Germany	3–35	3–35	3–35	3–35	0.7	0.7
United Kingdom	10–75	10–75	10–75	10–75	–	–
United States	18–55	18–55	18–55	18–55	–	–

a. Transfers between generations (direct line).

Source: OECD Report.

Finally, capital may also be taxed at the corporation level. Some countries recognize, at least in part, the double taxation of corporation income and thus allow tax credits for dividends paid out. In these cases, taxpayers gross up their dividend income, inclusive of pro rata corporation tax, with their other sources of income in the individual tax return before computing tax liabilities, and then take a credit for the tax paid at the corporate level. However expedient this procedure may be to relieve dividend income from double taxation, countries hesitate to adopt it, possibly in the fear of losing too much revenue.[15] As indicated in Table 5, only a fraction of the taxes paid at the corporation level is rebated in the individual tax returns in Canada, France, and the United Kingdom, except for Germany where a full rebate applies. Australia, Brazil, and the United States still cling to the "classical system" of fully separated taxes.

Table 5
Imputation of corporate taxes for dividends paid
(Rates in %)

Country	*Statutory tax on corporate income*	*Dividend tax credit*	*Statutory tax on dividend income after imputation*
Australia	46	–	46
Brazil	40	–	40
Canada	46	33	13
France	50	25	25
Germany[a]	36	36	–
United Kingdom[b]	52	20	32
United States	46	–	46

a. Non-distributed profits are taxed at a rate of 56%.
b. Rounded figure for dividend tax credit (exact figure 20.57%).

Source: IFA Seminar Paper, *Imputation Systems* (Montreal, 1982).

5. TAX EFFORT

Having laid down some basic structural features of capital income taxes in several countries, as well as in Brazil, we turn now to a comparative review of the statistics of income tax collection. Our purpose is to evaluate tax efforts in general and the personal income tax in particular, and also to verify to what extent these taxes contribute, in Brazil and abroad, to financing the bulk of federal government expenditures. The index of total tax receipts as a percentage of gross domestic product (GNP) provides an initial approximation of the overall national tax effort. Other sources of government revenue include borrowing, government enterprise surplus and deficit financing, all of which may be quite flexible and variable through time. We note that if a country relies heavily on these non-tax sources of revenue, as Brazil does, the statistics of tax effort underestimate the cost of government expenditures.[16]

Table 6 presents total tax receipts as a percentage of GNP, from 1965 to 1980, and shows that the Brazilian tax effort is substantially inferior to that of any other country considered in the sample. When we move to the composition of total tax receipts, in Table 7, we observe that, based on this comparative source of tax revenue, Brazil's individual income tax share is not as significant (10.5%)

15. For a recent and exhaustive study of international practice as well as conceptual problems involved in the integration of corporation and individual income taxes, see M. Norr, *The Taxation of Corporations and Shareholders* (Kluwer, 1982).
16. See C.A. Longo, "Quantificação do Setor Publico", in *A Crise do "Bom Patrão"*, P.R. de Castro (editor) (CEDES/APEC, Rio de Janeiro, 1982), 113–136.

as the contribution of indirect consumption taxes (52.6%) to total tax receipts. Table 7 also tells us that taxes on corporate income and social security are apparently well explored in Brazil, since their relative share is close to the average, thus indicating a reasonable tax effort with respect to these sources of revenue.

Now in Table 8 we look at country-by-country figures for the composition of central government tax receipts and find again that, in Brazil, taxes on indirect consumption and corporate income contribute a substantial amount of total tax receipts. In contrast, the share of the individual income tax in total tax receipts (30%) is by far the smallest of the sample. Often, the individual income tax contribution to central tax collection is about 4 times the corresponding contribution of corporate income tax; not so in Brazil, however, where this ratio is 2 times. Thus, if we need to raise taxes at the central level in Brazil, a good candidate in terms of current tax effort may be the individual income tax.

Table 9 examines the composition of income tax receipts in Brazil and the first thing to notice is that 90% of taxes collected from individuals are withheld at source: 54% are collected from wages, salaries and other labor income, 16% from interest, dividends, capital gains and other sources of capital income, and 20% from repatriated earnings.

Taxes withheld from wages, salaries and other labor income are in anticipation of taxes due on individual tax returns; thus, this source of income is necessarily grossed up on individual tax returns. On the other hand, income derived from interest, dividends, capital gains, etc. and repatriated earnings is liable to tax only at source without gross-up. In this context, if the contribution of income tax to total tax receipts has to be raised with increased reliance on ability-to-pay principles, then we ought to start thinking about how to bring interest, dividends, capital gains and other sources of capital income under the progressive rate schedule, since progressive rates cannot be applied to repatriated earnings and corporate income directly.

We believe we are not too far off in assuming, for reasons given above, first, that roughly ⅔ of real capital income is currently not reported in the individual tax returns, and, second, that the fully implemented gross-up of capital income could raise average effective individual tax rates by some 10 percentage points, due to progressivity. Thus, in such an event, if a gross-up requirement is passed by law and in its wake under-reporting is minimized, we dare to suggest that the combined impact of both a larger tax base and higher tax rates can well increase income tax receipts from interest, dividends, capital gains and other sources of capital income by a factor of 8, which may lead to almost double the current income tax collection! Of course, such a movement cannot be considered in the air; in fact, a tax reform of such magnitude should be accompanied by careful examination of the integration of corporation income tax with the individual income tax, reduction of aggregate government subsidies, as well as improvement of tax collection procedures.

Table 6
Total tax receipts as percentage of GNP
(All levels of government)

(Percentage – 1980)

Country	*1965*	*1970*	*1975*	*1980*
Australia	23.8	25.5	29.1	29.8[a]
Brazil	19.1	24.0	23.9	21.9
Canada	25.9	32.0	32.9	32.8
France	35.0	–	–	41.2[a]
Germany	31.6	32.8	35.7	37.2
United Kingdom	30.8	37.5	36.9	35.9
United States	26.5	30.1	30.2	30.7

a. 1979 figures.

Source: OECD Studies in Taxation (Paris, 1981); FGV/CCN (Brazil).

Table 7
Composition of total tax receipt
(All levels of government)

(Percentage – 1980)

Country	*Individual income*	*Corporate income*	*Social security*	*Indirect consumption*	*Property*
Australia	44.3[b]	10.3	–	28.1	8.6
Brazil	10.5[c]	5.6	32.3[d]	52.6	–
Canada	34.2	10.7	10.7	24.1	9.3
France[a]	12.5	4.7	42.8	30.5	–
Germany	29.9	5.5	34.1	25.8	2.6
United Kingdom	29.5	8.5	16.9	27.1	12.0
United States	36.9	10.1	26.3	14.4	10.1

a. 1979 figures.
b. Includes social security taxes.
c. Includes taxes withheld (capital, labor, repatriated earnings, etc.).
d. Direct tax receipts (CCN) less income tax receipts (DIPRO).

Source: OECD Studies in Taxation (Paris, 1981); FGV/CCN and MF/SRF/DIPRO (Brazil).

Table 8
Composition of central government tax receipts

(Percentage – 1979)

	Tax		
Country	*Individual income*	*Corporate income*	*Incirect consumption*
Australia[a]	55[b]	13	32
Brazil	30[c]	16	54
Canada	49	19	30
France	–	–	–
Germany	37	8	54
United Kingdom	44	11	32
United States	71	21	6

a. 1979 figures.
b. Includes social security taxes.
c. Includes taxes withheld (wages, interest, repatriated earnings, etc.).

Source: OECD Studies in Taxation (Paris, 1981); MF/SRF/DIPRO (Brazil).

Table 9
Composition of income tax receipt, Brazil, 1980

	Cruzeiros (millions)	Percentage	
Income tax	462.765	100	–
Corporate income tax	165.493	35	–
Individual income tax	299.272	65	100
Individual tax returns	30.377	7	10
Withheld at source	268.895	58	90
Wages, salaries and other sources of labor income	162.021	35	54
Interest, dividends, capital gains and other sources of capital income	47.603	10	16
Repatriated earnings	59.268	13	20

Source: MF/SRF/DIPRO.

Table 10
Individual income tax (IRPF), Brazil, 1980
(in %)

Gross income		100.00
Adjustments to gross income	20.54	
Adjusted gross income		79.46
Non-business deductions	21.98	
Taxable income		58.40[a]
Tax due		6.46
Credits	0.38	
Net tax due		6.09[b]
Withheld tax (adjusted for inflation)	7.16	
Excess contribution		1.07

a. The subtraction is 100 – (20.54 + 21.98) = 57.48. However, a small amount of exempt income is added to taxable income, i.e. of taxpayers who filed returns with deductions in excess of gross income.
b. Rounded off.

Source: MF/SRF/CIEF.

6. TAX ADMINISTRATION

High inflationary rates induce many distortions in the administration of income tax since tax liabilities and tax payments do not usually go together; legal adjustments for inflation on pre-paid taxes may not reflect actual currency devaluation, etc. It seems fair to say that with an inflation rate as high as 100% per year, tax officials and taxpayers are more interested in measuring and avoiding short-run unexpected gains or losses due to time lags, arbitrary indexation related to the enforcement technique under such inflationary constraint, rather than abstract notions of improved tax bases. However, linked as the notions of tax base and inflation rate may be, we postpone this discussion for a while and address in the following pages some important characteristics of income tax administration.

Table 10 indicates that taxable income is reduced to 58.40% of gross income as a result of schedular adjustments to gross income and non-business deductions. Most of these deductions – standard deductions for small taxpayers, allowances for dependents, cost of earning labor income – are fairly regressive, so that a major revenue increase cannot be expected from their revision. On the other hand, the amount reported as non-taxable income (stock dividends, capital gains on the sale or other transfer of stock of public corporations, gifts and bequests, etc.) and as income taxed at source only (cash dividends, interest, capital gains, etc.), which represents 51.41% of gross income, should be revised to increase tax revenues, since these tax preferences (e.g. loopholes) are highly progressive. However, we should not forget that a substantial share of non-taxable income and income taxed at source only is purely nominal gains and, in this sense, should not be taxed. Thus, the problem is not simple and a coherent outline of policy alternatives requires a broader perspective of the tax system.

The benefits of a policy of substituting tax revenues for other sources of budgetary finance are unclear and have been contested on quite varied, and apparently contradictory, grounds. First, the burden of aggregate taxes, and of income taxes in particular, has been perceived by many analysts and the public in general to be excessive and regressive,[17] and, second, statistics of tax revenues by source show that approximately 60% of income tax collections are derived from capital income.[18] These statements are correct in themselves but beg the more fundamental question as to how best to finance government expenditures, since the current inflationary tax is excessive and may be highly regressive as well. Furthermore, as pointed out earlier, even though the share of taxes raised from wages, corporate income, and some sources of capital income is higher than from other sources of Brazilian revenue, tax effort from income taxes in general, and from capital income tax in particular, is significantly lower than in other countries. Finally, as empirical studies of tax incidence have shown, effective rate schedules of individual income taxes may be quite low, as compared to legislated schedules; as opposed to other taxes whose actual incidence is too sensitive to transference assumptions, the individual income tax is still basically progressive.[19]

7. CONCEPT OF INCOME

Tax reform discussions usually point to the distortionary effects of major tax preferences which in turn lead to proposals for greater coverage by existing tax law.[20] This, in short, means that we must utilize an ideal concept of the tax base and, whenever possible, try to approximate it through tax reform. Henry Simons' definition of income has received much attention precisely as such an ideal concept, where income for purposes of personal taxation is defined as "the algebraic sum of the individual's con-

17. Indirect consumption taxes are regressive and an income tax system which includes wages but exempts most capital income seems to be regressive, too.
18. Taxes collected from capital include: corporate income tax, withheld taxes on interest, dividends, capital gains, and repatriated earnings. See Table 9.
19. J. Pechman and B. Okner, *Who Bears the Tax Burden* (Brookings, Washington, D.C., 1974), p. 61; I. Eris et al., "Distribuição de Renda e o Systema Tributario no Brasil" (Anais da Anpec, Atibaia, 1979).
20. Not always, however, since goals for tax reform depend also, and critically, on the underlying analytical background of tax reformers. In the tradition of "optimal tax theory", tax reformers will typically accept the current state of affairs and simultaneously favor compensatory taxes based on product and factor elasticities of demand and supply. See, for example, M. Feldstein, "Compensation in Tax Reform", 29 *National Tax Journal* 2 (June 1976), 123–130.

sumption expense and accumulation during the accounting period". In other words, income is the "net accretion of one's economic power between two points in time".[21]

Measurement of the appropriate concept of income, for purposes of personal taxation,[22] presents grave difficulties, since "accretion" includes accrued gains which result from changes in net wealth as well as realized ordinary income. Simons recognizes that "outright abandonment of the realization criterion would be utter folly" and makes concessions to administrative necessity, *during* the taxpayer's lifetime, by omitting from the tax base accrued gains not yet realized. Thus, taxes on accrued gains may be delayed until the time of sale, gift or death. In principle, all receipts from gifts, inheritances and realized windfalls should be included in determining the basis of individual "economic power" under income taxes, and all earning income expenses such as interest, depreciation, and losses should be deducted.

8. CHOICE OF TAX BASE

Many imperfections found in actual tax structures derive from the lack of agreement as to what is, or ought to be, an ideal tax base. *Blueprints for Basic Tax Reform* explicitly laid down four different choices of broad-based taxes, equally acceptable in principle, which depend on whether or not savings and/or inter-generational transfers are included in the tax base.[23] In a lifetime perspective, the choice between the consumption and income bases is less apparent but still a decision must be made on whether to include gifts and bequests in the base. If income or consumption ability-to-pay is chosen as an appropriate criterion, then gifts and bequests are included in the tax base of the donee and inheritor (donor and deceased), as proposed by Simons.

There is no agreement, however, on whether taxes should be applied equally to all taxpayers. Only if individuals have identical tastes and productivity is income (or consumption) a perfect surrogate for utility. Under these conditions, two individuals with identical "Henry Simons" income will enjoy the same level of utility and should be taxed equally. Otherwise, if two individuals place different values on their leisure time yet earn the same income, their levels of satisfaction are bound to be different. Similarly, if two individuals produce different output from their work effort, yet have the same income, their levels of satisfaction also are bound to be different. Therefore, given that tastes and productivities differ among individuals, and that actual taxes are by necessity applied on income only, it may well be futile to search for an ideal tax base.[24]

Along these lines, optimal tax theorists do not really care about an ideal tax base, assuming this is a second-best world. Since enforceable ability-to-pay is not consistent with inter-personal equity, it is generally not optimal to pursue a broad-based tax reform. Furthermore, as a competitive market system tends to capitalize tax advantages into higher market prices in such a way as to remove their advantages, tax preferences are not necessarily a source of inequity, and any reform of the existing Code may create horizontal inequities through unanticipated gains and losses.[25] This is a telling argument in favor of piecemeal adjustments to the status quo based on decentralized pressures of special interest groups, each properly equipped with cost-benefit analyses which duly support their particular views.

On the other hand, if we believe in a decentralized decision-making process, guided by private economic incentives, simpler rules must apply, and the appeal of broad-based taxes is again most compelling. In such cases, we must be prepared to assume that tastes and productivities are essentially equal among individuals, so that standards of interpersonal equity are not too much violated when we choose either the income or the consumption base.

Let us examine more closely one fundamental problem associated with adoption of a broad-based income tax according to the ability-to-pay criterion. The income base is conceptually marred by the elusive definition of capital: the price or the value of a piece of capital asset depends on its capitalized future income which, in turn, cannot be determined independently of its price. Thus, in the real world, when prices change during the fiscal year, due to the interaction of supply and demand, it is not possible to discriminate between ordinary income (capital income) and capital gains. Alternately, looking at the "use of income" side, it is difficult to distinguish between consumption expense and net savings (change in net worth). Income, as defined by Hicks, is the amount an individual can spend during a fiscal year and still remain in the same welfare position, i.e. with unchanged capital assets.[26] However, increased income derived from the ownership of more goods is indistinguishable from increased income which results from their higher relative prices. In this sense, as Kaldor points out, income is consumption plus net savings, and the problem of defining income is identical to the problem of defining net savings, which in turn is identical to the problem of defining what is understood by keeping the value of capital unchanged in a given period. "A solution of any one of these three problems should therefore automatically carry with it the solution of the other two."[27]

In practice, actual tax structures differ significantly from their broad-based conceptual counterparts. Tax expenditures, as defined by Surrey in 1967, refer to departures from the Haig-Simons base translated into revenue losses which result from generous provisions of the income tax law in the form of deductions and exclusions

21. H. Simons, *Personal Income Taxation* (Chicago University Press, Chicago, 1938), p. 206.
22. National income accounting is primarily concerned with an estimated measure of the aggregate value of goods and services produced in a given period, as opposed to economic resources available (ability-to-pay) to an individual (or his family) during that time. These measures, in general, do not coincide since inter-individual transfers via tax system, price changes, gifts, bequests, lotteries, etc. do not affect national income but do affect personal "economic power". See Simons, *Personal Income Taxation,* chapter 2.
23. U.S. Treasury Department, *Blueprints for Basic Tax Reform* (Government Printing Office, Washington, D.C., 1977), Chapter 2.
24. See R. Tresch, *Public Finance: A Normative Theory* (Business Publications, Plano, Texas, 1981), Chapter 13.
25. M. Feldstein, "On the Theory of Tax Reform", *Journal of Public Economics* (July-August 1976).
26. J. Hicks, *Value and Capital* (Oxford University Press, London, 1946).
27. N. Kaldor, *An Expenditure Tax* (Allen and Unwin, London, 1955), p. 57.

from gross income, tax credits, reduced rates and tax deferrals.[28]

How generous these provisions are is a controversial issue, since this "generosity" depends on the definition of the tax base.[29] Definitions aside, beginning in 1974, budgetary law in the United States displayed tax expenditures as well as direct government expenditures for Congressional consideration. The importance of tax expenditures to the budgetary decision-making process can hardly be over-emphasized, because, for instance, in 1978, it accounted for 26% of direct expenditures and 200% of federal budget deficit. Seventy-five percent of these tax expenditures are granted to individuals as preferential treatment of capital gains, exclusion of employer contributions to pension, health, and welfare plans, and deductions of state and local non-business taxes.[30] No equivalent estimates of tax expenditures are available for Brazil, since these tax expenditures are not subject to explicit consideration by the Congress. However, tentative scholarly research indicates that these departures from the Haig-Simons' base should not be small. Taking into account only those departures from the legislated tax base in the form of investment tax credits to targeted activities and regions, Varsano estimated that corporation income tax and individual income tax revenues were reduced by 39.2% and 28.8%, respectively, in 1975.[31]

Optimal tax theory tells us that both tax expenditures and direct expenditures lead to distortions (in the economic sense) and that the choice between them to finance targeted activities should be decided on empirical grounds depending upon the magnitude of the compensated own and crossed elasticities of demand for the target activity and leisure. In particular, given the size of the budget, tax (direct) expenditures should be preferred to direct (tax) expenditures as a source of finance when the quantity demanded for the target activity is (is not) significantly affected, and the supply of leisure is not (is) sufficiently affected by these tax subsidies.[32]

As much as definition problems may hinder the application of broad-based tax reforms, the notion of optimal tax subsidies depends crucially on reliable, but hard to attain, estimates of demand and supply elasticities. Thus, neither Haig-Simon tax reformers nor optimal tax theorists can claim that, in principle, their approach is necessarily preferred. However, we argue, with the Brazilian case in mind, that tax subsidies may easily get out of hand when utilized on a large scale. Firstly, when tax subsidies are widely utilized, it becomes difficult to distinguish which sector, if any, is really a *net* beneficiary of the tax system.[33] Secondly, it becomes rational for every economic agent to fight strongly for its own tax breaks irrespective of cost considerations, since these costs are shared by the taxpayer at large, usually through increased deficit financing.

From the investor's point of view, tax subsidies reduce the effective tax rate on the return of targeted activities through the mechanism of tax deferral, accelerated cost deductions, and/or investment tax credits. Given the opportunity, the taxpayer has an incentive, which is directly proportional to his total income, or tax bracket, to couple these special tax provisions with leveraged investments in such a way as to convert tax liabilities into negative taxes (subsidies) in the target activity.[34]

When all is said and done in terms of investment tax breaks, it should come as no surprise to the analyst that what we are in fact taxing is not income but something else. What then? It is not consumption, since dis-savings may not be included in the tax base, for example, in a life cycle context, the consumption by the donor or inheritor of appreciated gifts and bequests. The conceptual counterpart of a tax structure which exempts both the return of capital (savings) and accrued gains on inter-generational transfers (gifts and bequests) is *own* consumption, or consumption standard-of-living in the language of the *Blueprints for Basic Tax Reform,*[35] or, even more specifically, labor income. However, if investment tax breaks may be justified as an incentive to capital accumulation in general, very few things could be said in favor of exempting dis-savings from the tax base.[36]

A base which avoids the problem of excluding dis-savings, at least among generations, and still favors capital accumulation is consumption ability-to-pay. Furthermore, this case is attractive on administrative grounds in the sense that it leaves aside many complex computations of net savings, such as depreciation, adjustments for inflation, realized gains, etc.[37]

Under certain conditions a tax on consumption ability-to-pay is equivalent to a tax on permanent income. To understand this proposition a simple example may suffice. Suppose an individual who starts off his career with no gifts and bequests invests all his wage income in real estate, and consumes very little in relative terms which allows us to assume that his consumption is equal to zero. In such cases, taxes collected from realized permanent income would be equal to taxes collected from consumption ability-to-pay since gifts and bequests are included in the latter, if tax rates are properly converted from flow basis (income) to stock basis (gifts and bequests).[38] A policy implication suggested by this example is that an income tax system which, by and large, neglects to include investment income as well as accrued gains as a result of gifts and bequests in its base is actually a tax on labor in-

28. S. Surrey, *Pathways to Tax Reform* (Harvard University Press, Cambridge, 1973).
29. See C. Shoup, "Surrey's Pathways to Tax Reform – A Review Article", 30 *The Journal of Finance* 5 (December 1975), 1329–41.
30. W. Andrews, *Basic Federal Income Taxation* (Little Brown, Boston, 1979), pp. 319–321.
31. R. Varsano, "Os Incentivos Fiscais do Imposto de Renda das Empresas", *Revista Brasileira de Economia* (1981); "Notas Preliminares Sobre os Incentivos Fiscais", INPES/IPEA Mimeo, 1978.
32. See M. Feldstein, "The Theory of Tax Expenditures", Discussion Paper 435 (Harvard, 1975), p. 22.
33. R. Varsano, "Incentivos Fiscais: Supressão o Reformulação?", 13 *Rumos do Desenvolvimento* 16 (1979), 30–33.
34. See Andrews, *Basic Federal Income Taxation* pp. 450–52, 532–34.
35. *Blueprints,* p. 33.
36. See A. Warren, "Fairness and Consumption–Type or Cash Flow Income Tax", and W. Andrews, "A Reply to Professor Warren", in 88 *Harvard Law Review* 5 (March 1975), 931–58.
37. The advantages of a lifetime expenditure tax have been explored recently in J. Kay and M. King, *The British Tax System* (Oxford, 1980), Chapter 6.
38. Strictly speaking, the value of tax deferral during the taxpayer's lifetime would have to be considered too, even though we are not concerned here with distortions within a lifetime.

come, which most certainly is not what the legislature meant it to be.

How can one implement, if at all desirable, an individual consumption tax, which no country has yet tried? In spite of the lack of empirical evidence, and as illogical as it may appear at first sight, it seems that no major changes in the current tax law would be necessary, since individual consumption can be measured by cash flow during the fiscal year. All wages, interest, and dividend income, the value of gifts and bequests, and the amount realized on sales and personal borrowing would be included in the tax base, and the value of purchased assets, debt amortizations, as well as exemption levels, would be excluded from the tax base. Thus, taxes would be collected at source, as currently, but special accounts would have to be created in order to help taxpayers keep track of their financial transactions and, also, to minimize tax avoidance. Each taxpayer would open a special account for registered assets with a financial institution where deposits to (drawings from) this account to purchase (sell) financial assets would be deducted from (added to) taxable cash flow.

An alternative method for treating investments, adequate for reasons of simplicity in dealing with durable goods, is to include in the tax base the amount of the investment and exclude therefrom its derived consumption. But this is automatically obtained if taxpayers do not utilize their special account, which is equivalent to a prepayment of the tax on the basis of future consumption's present value.[39]

9. CONCLUSION

Disregard for explicit notions of the tax base has brought us to the situation where the Brazilian federal government finances general expenditures basically with progressive taxes on labor income, random taxes on capital income, and excludes from the tax base dis-savings, most of which are financed with tax-exempt capital gains. The widespread use of tax expenditures substantially reduces the contribution of income taxes to total tax receipts and furthermore induces excessive use of tax-shelter investments which unduly increase the social cost of tax collection and further distort the progressivity of the income tax.

Tax shelters refer to investments that are sheltered from ordinary income tax through deferral and/or anticipation of investment cost deductions. Income deferral results from the principle, derived in court decisions, that realization of the gain is necessary to generate taxable income; and anticipation of deductions results from the possibility of depreciating leveraged (i.e. financed by borrowed funds) investments as well as from investment tax credits and accelerated cost depreciation provided in the tax statute. Although many of these provisions are the outcome of specific legislation, basically the concept of tax shelters, as opposed to tax expenditures, is not the outcome of deliberated policy and follows, to a great extent, from the inherent difficulty of implementing appropriately the income base.

Adequately combining income deferral with accelerated cost deductions, taxpayers may completely avoid taxes on ordinary income and also invest with borrowed funds in activities which generate non-taxable income in the form of accrued capital gains. Consider, for instance, a taxpayer with $100,000 of ordinary income in the 50% tax bracket, with a 10-year life expectancy, who invests, say, $500,000 in borrowed funds in a 10-year project whose net gain accrues entirely in the last year. Under linear cost depreciation, the taxpayer is able to avoid taxes on ordinary income, nor is the accrued gain on the project taxed, if the underlying asset is transferred by gift or death. In this case, the effective rate of tax for this 50% bracket taxpayer is zero, and, furthermore, the rate of return on his investment is infinite, since the taxpayer's contribution to the project is zero.[40]

The simplest and most common procedure to shelter capital income from taxes is, of course, to invest in real estate and durable goods: houses, land, paintings, etc. These assets do not yield taxable income, which in this case is partly implicit consumption and partly accrued capital gains. Thus, tax shelters not only reduce potential revenue and distort progressivity, but also encourage conspicuous consumption.[41] As in many underground economic activities, tax shelters cannot be completely eliminated. Even in industralized countries, higher bracket taxpayers, with the advice of professional tax specialists, reduce substantially their tax liabilities through tax shelter investments (e.g. trusts, life insurance companies) or special partnerships created to take advantage of legislated accelerated cost depreciation and investment tax credits.[42]

In Brazil, presently, it is not necessary to stretch one's imagination to avoid capital taxation in the individual income tax. In fact, fortunes can easily be amassed, and realized too, in stocks of public corporations and bearer bonds and also in housing, land, stocks in general, as long as retained for a number of years without incurring any personal income tax. The current individual income tax can be seen, in practice, as a progressive tax on labor income combined with an indirect and random tax on capital income. Widespread use of withholding tax on certain items of capital income without requiring grossing up and identification of the taxpayer induces excessive tax avoidance and evasion as well.

Given that the tax effort level, and especially of the individual income tax, is comparatively very low in Brazil, and considering the economic distortions and inequities related to the actual tax structure, it is incomprehensible that the government hesitates, and Congress follows suit, even to consider a major tax reform. Failure to realize that inflation rates running close to 100% a year may have something to do with how revenues are raised leads most tax specialists to concentrate efforts on small

39. *Blueprints for Basic Tax Reform,* Chapter 4; Kay and King, *The British Tax System,* Chapter 7.

40. For details, see Andrews, *Basic Federal Income Taxation,* pp. 450–52; 532–34.

41. In other words, tax shelters undermine economic efficiency since the higher the level of tax rates necessary to finance a given level of public services the more attractive such shelters will be. Thus inefficiency is directly related to the level of tax rates. See, for instance, Tresch, *Public Finance: A Normative Theory,* Chapter 15.

42. Kay and King, *The British Tax System,* Chapter 4; S. Surrey et al., *Federal Tax Reform for 1976* (Fund for Public Policy Research, Washington, D.C. 1976).

adjustments in the tax law instead. At this pace income tax revenue will become less and less important as a source of finance to the federal budget (broadly defined), which will rely more and more on alternative sources, such as indirect taxes, borrowing, deficit finance and public enterprise revenues. As a consequence, the social decision-making process may become less transparent with the executive branch of government and public enterprise management tending to hypertrophy and substituting in the allocation of resources and pricing policies the role traditionally reserved to budgetary review and/or the private sector.[43]

Five specific policy suggestions follow from this discussion which basically support an increase in the share of individual income tax in lieu of other sources of revenue, given the level of federal government expenditures. First, require the grossing up of all income derived from interest and dividend income and capital gains in the individual tax return. Second, substitute a flat tax credit for investment in public corporation assets for the current exclusion from taxable income of capital gains realized on these assets. Third, disallow the exclusion from taxable income of 50% of net income realized in the agricultural sector. Fourth, drop the exclusion from taxable income of capital gains realized with financial assets, in general, after 5 years, and with real estate assets after 20 years, with increasing deductions up to that year. Fifth, recognize gains accrued on inter-generational transfers by gift or death as realized and therefore as taxable income,[44] or at least require a carry-over basis to the donee or inheritor.

Each of the proposed measures requires, in order to minimize their financial impact in the short run, careful consideration, such as adjustments of the base for inflation, averaging of bunched gains, the choice of exemption levels, tax rates, and tax credits, etc. However, difficulties related to the implementation of this broad-based tax reform should not overshadow the basic purpose of the reform, which is to substitute revenues so as to increase progressivity and minimize economic distortions. In this sense, it would be preferable to discuss the proposed measures together in a package, with the proviso that if they are approved, implementation would not take place before a given number of years.[45]

If proposals to broaden the income tax base prove unamenable, in terms of reaching a political consensus, because tax incentives to capital accumulation must be kept at any rate, or due to the administrative complexities related to estimating net savings in an endemic inflationary economy, then perhaps this might be an appropriate time to start a serious discussion of the pros and cons of a broad-based personal consumption tax for Brazil.

43. For a critique of the Brazilian state of affairs along these lines, see P.R. Castro, "O Estado Gigante: Excesso de Ação e Crisede Eficiencia", 36 *Conjuntura Economica* 7 (July 1982), 81–86.
44. For a similar proposal, see H. Tilbery and I. Martins, "Tributação de Acrescimos de Patrimonio, Ganhos de Capital, Doações, Herancas e Legados", 1st Congresso Brasileiro de Direito Financeiro, Mimeo, Rio de Janeiro, 1980.
45. Any tax reform imposes cost and benefits related to the ownership of factors in the status quo. These inequities may be minimized by allowing gradual capitalization of the new order. See M. Feldstein, "Compensation in Tax Reform", 29 *National Tax Journal* (June 1976), 123–130.

BRAZIL:
New Incentives for Company Capitalization

By Aleksas Juocys

1. Decree-Law 1,994 of 29 December 1982 created an incentive for the capitalization of companies by instituting a "financial credit" for legal entities established in Brazil.

2. This incentive is intended to encourage the capitalization before 31 December 1983 of the principal and/or interest of:
(a) direct foreign currency loans, the proceeds of which entered Brazil before 30 January 1983;
(b) loan facilities in connection with financing of imports of goods or services in those cases in which the goods were shipped or the funds for the payment of the goods, services or local expenses were disbursed before 30 December 1982.

3. The financial credit will also be available for equity capital increases made from 30 December 1982 to 31 December 1983 by means of the injection of new foreign or local funds. In this case the credit is not available for insurance companies, financial institutions and other entities authorized to operate by the Central Bank of Brazil, nor to legal entities in which the majority of the voting capital is directly or indirectly held by a legal entity of public law, a state company or a mixed-economy company.[1]

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4. The financial credit mentioned in 3 above applies only to that portion of the capital increase in companies formally organized before 30 December 1982 effected by (i) individuals resident in Brazil, (ii) insurance companies to cover their technical reserves, (iii) private pension entities, (iv) jointly-owned funds, (v) investment companies, and (vi) individuals or legal entities resident or domiciled abroad, that is represented by an investment registered at the Central Bank of Brazil.[2]

5. In the case of 2(a) above, the financial credit is 10% if the capital increase is made before 30 June 1983 and 5% if made from 30 June 1983 to 31 December 1983. These percentages apply to the principal and/or interest so capitalized, based on the cruzeiro sum actually capitalized and converted at the exchange rate prevailing on the date of capitalization.[3] In the cases described in 3 and 4 above, the financial credit is 5% of the amount of the capital increase paid up in cash before 31 December 1983.[4]

[Continued on page 310]

1. Ordinance No. 69, issued by the Minister of Finance on 29 March 1983, item 2 ("Ordinance No. 69").
2. Ordinance No. 69, item 1.
3. Ordinance No. 13, issued by the Minister of Finance on 12 January 1983, item 1(a), ("Ordinance No. 13").

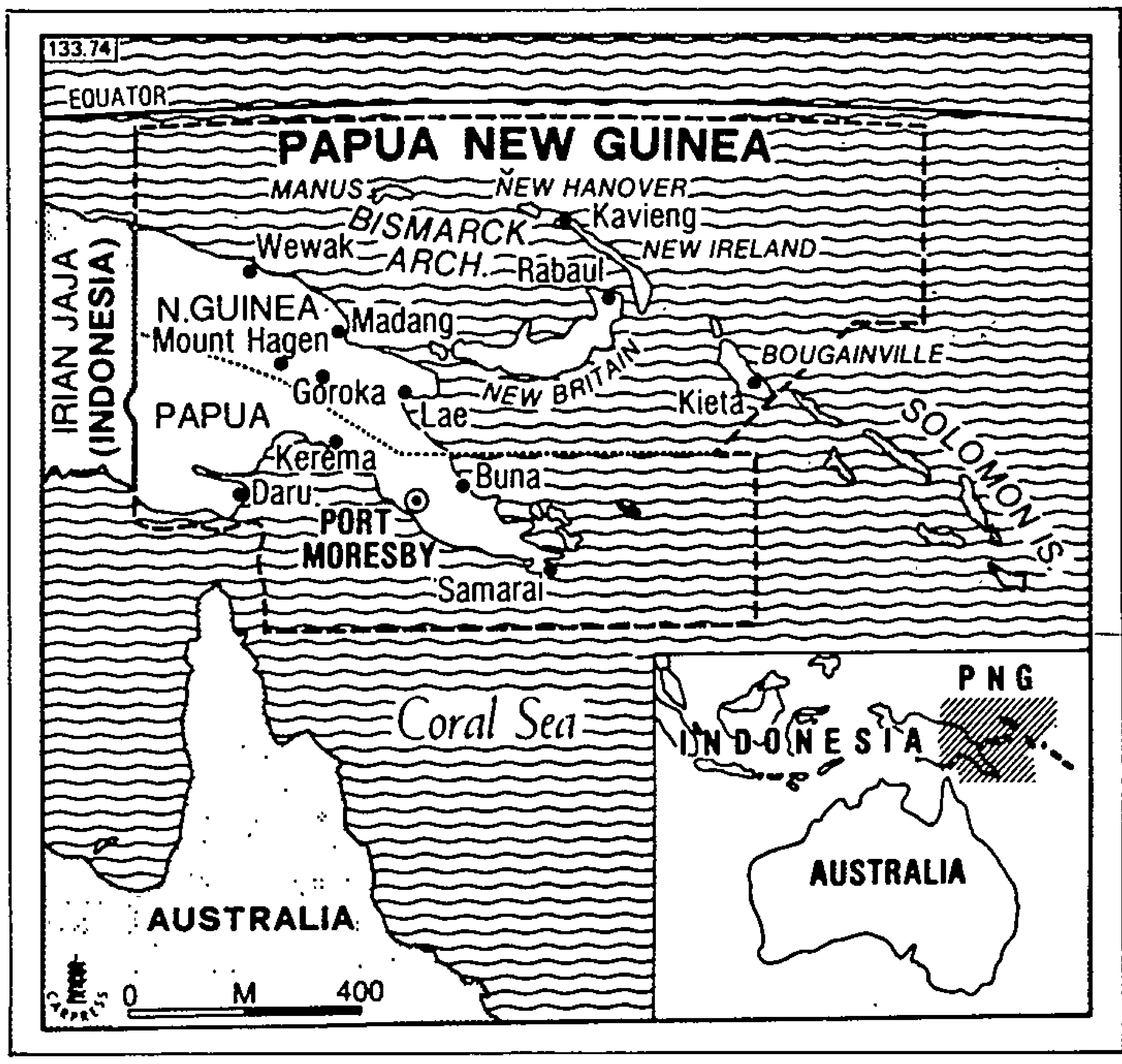
Papua New Guinea 1983 Budget Income Tax Amendments

by Stewart Naunton

With a population exceeding 3 million and a gross domestic product estimated at approximately US$2,350 million in 1980, Papua New Guinea is the largest of the developing island nations of the Pacific. Traditional subsistence agriculture fully supports 72% of the population. The cash economy is heavily dependent on trade, consuming relatively little of what it produces, and consequently importing a large proportion of goods for domestic consumption. These features have significant effects in shaping tax policy in Papua New Guinea.

The purpose of this article is to examine the amendments to income tax legislation which arose from the 1983 Budget, brought down in Parliament on 9 November 1982 by the Hon. Philip Bouraga, Minister for Finance.[1]

Total National Government revenues of 620 million Kina (US$734 million)[2] *are budgeted for 1983. Of this total, personal and corporate income taxes account for 155 million K (US$183 million). The balance of revenue is expected to be raised from Australian aid of 212 million K (US$251 million), from indirect taxation, principally import and excise duties, dividends from statutory corporations and mineral revenues. However, since relatively little published material is available, the article is prefaced by a brief summary of the tax system in Papua New Guinea.*



THE TAX SYSTEM

Income tax was first introduced in 1959. At that time Papua New Guinea was an Australian territory, the economy was largely in Australian hands and very few indigenous people were within the income tax net. In these circumstances, it was logical that the Income Tax Act was a close, slightly simplified copy of the Australian income tax legislation. That tradition has continued beyond independence in 1975 to the present day, when its relevance to Papua New Guinea's circumstances is more doubtful. The basic scheme of the Income Tax Act coincides with that in Australia and many provisions are identical in wording. Australian case law, while not binding, has persuasive authority and has invariably been followed in practice to date. Since independence there has been a gradual development of withholding-type taxes, which diverges from Australian practice. These have been aimed at transactions with non-residents and at the interface between the organised economy and the informal cash economy. An example of the former is the tax on non-resident construction contractors, and of the latter, a withholding tax on sales of alluvial gold.

Income tax is imposed on the world-wide income of Papua New Guinea resident entities and on the Papua New Guinea-source income of non-residents. The legislation taxes gross income, excluding exempt income and subject to allowable deductions. Losses and expenses of a revenue nature incurred in deriving income or in carrying on a business are deductible. Capital expenditure is not generally deductible; however, tangible income-producing assets may be depreciated at prescribed rates and some kinds of capital expenditure in specific sectors, such as agriculture and mining, may be deductible or amortisable. There is no intrinsic nexus in the timing of the assessment of income and the allowance of relative deductions: broadly, income is assessable when earned under normal principles, a deduction is allowed when the liability is "presently incurred", not necessarily on an accruals basis.

Dividend income, of both resident and non-resident shareholders, is subject to a 15% withholding tax. This is

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1. For extracts from the Budget Speech, see 37 *Bulletin for international fiscal documentation* 3(1983) at 135.
2. Conversions throughout this article are at 1 K = US$1.1838, the Westpac Bank selling rate on 18 April 1983.

a final tax on non-residents. A resident individual may credit the withholding tax against his income tax liability on the dividend. Resident companies are, in effect, not taxed on dividend income; any withholding tax credit can be used to frank withholding tax due when dividends are paid.

There is no distribution requirement nor any direct tax on undistributed profits. However, distributions out of revenue reserves in an actual or deemed liquidation of a company may be treated as dividend payments.

There are provisions for deeming a Papua New Guinea source and imposing withholding taxes on certain transactions with non-residents, including royalties (widely defined), sales of goods, freight carriage, construction projects, interest, insurance and consultancy fees.

Salary or wages income is subject to a final tax deduction on a fortnightly basis at rates broadly equivalent to the normal income tax rates. Because salary or wages tax is a final tax, there can be no adjustment if the tax deducted over a year is greater than the equivalent income tax would have been.

The rates of income tax are 36.5% for resident companies, and 48% for non-resident companies (which are not liable to dividend withholding tax). Individuals are taxed at progressive rates, with a top rate of 50% on taxable incomes exceeding 30,000 K (US$35,514) per annum.

Apart from modest stamp and probate duties, capital transactions have not been taxable in Papua New Guinea. Profits from the sale of assets acquired for sale at a profit are taxed as income. A new tax on certain share sales was introduced from 1983 and is described below.

THE 1983 BUDGET

The 1983 Budget comes at a time of severe recession in Papua New Guinea, as in the world economy. The country is largely dependent on export earnings from minerals (principally copper and gold) and agricultural commodities (principally coffee, cocoa and copra). The market for all these commodities was severely depressed at the time of the Budget, with only slight recovery since then. Consequently, the Papua New Guinea government finds itself in the now common situation of a stable or contracting revenue base, an increasing (if moderate) debt service burden, and little scope for squeezing more revenue from business without stifling such activity as continues.

The Government has recognised this situation in its Budget and has sought to tackle its problems by trimming expenditure, rather than raising revenue. Indirect taxation has been increased, particularly on non-essential items such as luxury cars and alcoholic liquor. The strategy with direct taxation has been to maintain the stability which has been a feature of the income tax system. The rates and levels of income tax have not been disturbed, but there has been an attempt to tax specific situations which had been imperfectly caught by the pre-existing tax legislation, or where enforcement provisions were regarded as deficient.

The most significant amendments are the introduction of comprehensive transfer pricing legislation, a limited and unusual form of capital gains on share sales, strengthened enforcement procedures for non-resident construction contractors, and deemed liquidations of dormant companies. These amendments are examined in turn below, followed by an account of the other amendments contained in the legislation.

REFERENCES

The Income Tax (Budget Provisions) Act 1982 amends the Income Tax Act 1959. Unless otherwise stated, all references are to the Income Tax Act 1959.

TRANSFER PRICING

The Papua New Guinea economy is particularly vulnerable to the adverse tax and foreign exchange consequences of price manipulation. Much domestic production is exported, most goods for domestic consumption are imported. A substantial proportion of Papua New Guinea business is controlled by non-citizens. The economy and administration remain heavily dependent on foreign expertise, both resident and non-resident.

Transfer pricing is commonly perceived as a game played by large transnational corporations. This is not necessarily the case in Papua New Guinea, where transfer pricing is a tempting device for medium-sized businesses. This may well be a consequence of exchange control and migration policies. As a recently independent country, emerging from a colonial economy, Papua New Guinea has not encouraged non-citizen businessmen to expect more than a temporary period of operation in the country. However, such businessmen are regarded as permanent residents for exchange control purposes and their opportunities to invest and provide for their eventual removal overseas are severely curtailed. Consequently, the desire to establish a "safe haven", to accumulate funds overseas, may be for this class of businessman a more significant motive in adopting transfer pricing practices than the avoidance of Papua New Guinea tax which is its consequence.

The Income Tax Act includes a substantial armoury of legislation empowering the Chief Collector of Taxes to deem or determine Papua New Guinea source to income arising from transactions involving non-residents, to which brief reference has been made above. However, prior to the recent amendments, only Section 197 contained a general provision for the Chief Collector to determine the appropriate quantum of taxable income derived from a non-arm's length international transaction.

Section 197 reproduced, almost verbatim, the former Section 136 of the Income Tax Assessment Act of Australia, and proved to be of limited application. The section empowered the Chief Collector to determine the proportion of total receipts (including credit) of a business which should be taxable in Papua New Guinea. However, the Section applied only to business receipts and not to other kinds of income; it could not impute receipts which might have arisen in an arm's length dealing but did not in fact arise; and it applied only to businesses controlled by non-residents and not to businesses controlled by residents of Papua New Guinea. The final nail in the coffin of this Section was provided by the judgment in the Australian case of Federal Commissioner of Taxation v. Commonwealth Aluminium Corporation Ltd. (80 ATC 4371). In this case it was held that where the de facto management control of a business was exercised by its directors, and a majority of those directors were residents, then the business was not controlled by non-residents for the purposes of Section 136 of the Australian Act. This judgment opened the way for transfer pricing practices by manipulating the composition of boards of directors of companies whose shareholdings were controlled by non-residents.

The Australian response to this situation was contained in the Income Tax Assessment Act 1982 of May 1982. It comprised a repeal of Section 136 and its replacement by the comprehensive and detailed legislation which now forms Sections 136AA to 136AG of the Income Tax Assessment Act. The Australian example was followed in Papua New Guinea by the repeal of Section 197 and the enactment of Sections 197A to 197G with effect from 1 January 1983. These new sections are for all practical purposes identical with Section 136AA to 136AG of the Australian Act.

The subject of the legislation is an "international agreement", which is defined in Section 197C as an agreement for the supply or acquisition of property by a non-resident, otherwise than through a permanent establishment in Papua New Guinea, or an agreement for the supply or acquisition of property by a resident of Papua New Guinea in connection with a business carried on outside Papua New Guinea by that resident. "Agreement", "supply", and "property" are very widely defined so that, for example, the provision or receipt of services is included. The term "permanent establishment" follows the general definition in the Income Tax Act, with the specific addition of a place at which the taxpayer's property is manufactured. The general definition, in Section 4(1), is rather more detailed than is usual in double taxation treaties. It encompasses any place of business including: business carried on by an agent; the installation or use of substantial machinery or equipment; engagement in a construction project; and a place of manufacture, assembly, processing, packing or distribution if the taxpayer is affiliated with the manufacturer, assembler, etc.

Section 197D, subsections (1) to (4), provides for the determination of the consideration to be applied to an international agreement for income tax purposes. The provisions apply if:

(a) property is supplied or acquired under an international agreement; and
(b) the Chief Collector, having considered the relevant circumstances, is satisfied that two or more parties to the agreement were not dealing at arm's length; and
(c) the consideration for a supply was inadequate or nil, or excessive for an acquisition of property; and
(d) the Chief Collector determines that the provisions should apply.

In these circumstances the arm's length consideration is, for income tax purposes, substituted for the actual consideration. Subsection 197D(4) includes a residual power for the Chief Collector to determine the deemed consideration for income tax purposes if it is not possible or practical for him to ascertain the arm's length consideration.

It should be noted that the Chief Collector's powers of determination, whilst extensive, are not uncontrolled. It is well settled in case law that a determination such as that to apply these provisions has to be made "according to the rules of reason and justice" (Sharp v. Wakefield (1891) AC 173) and not wilfully. It is thought that the Chief Collector could not fall back on his powers under subsection 197D(4) without having first taken steps to establish what the actual arm's length consideration should be. However, any determination would be one of fact, rather than of law, and the review bodies are usually reluctant to disturb such findings unless the taxpayer can convincingly demonstrate that the determination represents an incorrect application of the law to the facts of the case.

Arm's length consideration is defined in subsection 197A(3) as the consideration which would have arisen under "an agreement between independent parties at arm's length". This definition scarcely resolves the question of what "arm's length" precisely means, which could well become the subject of future litigation. However, the helpful Canadian case of Swiss Bank Corporation and others v. MNR (71 DTC 5235) indicates that parties would not be regarded as at arm's length if they act in concert in the same interest, or are controlled by the same "mind".

Section 197E provides for the Chief Collector to determine the source of any income, and to apportion income or expenditure to any particular source, in cases to which Section 197D applies. The provisions are extremely detailed and encompass situations involving partnerships, trust estates and their beneficiaries, and businesses conducted in more than one country. Subsection 197E(7) specifies the factors to be considered by the Chief Collector in making any determination under Section 197E. These are:

(a) the nature and extent of the taxpayer's business and the place or places at which it is carried on;
(b) where a business is conducted through a permanent establishment, the circumstances which might be expected to have existed if it had been a separate entity dealing at arm's length; and
(c) any other matters the Chief Collector considers relevant.

Section 197F empowers the Chief Collector to make compensating adjustments in situations to which he has applied Section 197D. Thus, if the Chief collector applies an arm's length consideration to increase the assessable income or decrease a deduction of a taxpayer, he may adjust the assessable income or deductions of any taxpayer if and to the extent that he considers it fair and reasonable so to do. The obvious application would be to adjust the results of the other parties to an agreement, but it is also conceivable that it would be appropriate to adjust the results of the taxpayer himself, if for example Section 197D operated to accelerated income or to defer a deduction. Section 197F includes provision for a taxpayer to request a determination under that Section by the

Chief Collector and for objection or appeal against any such determination.

The application of the transfer pricing provisions of Sections 197A to 197F could overlap with Sections 60 to 65. These latter provisions concern businesses carried on partly within and partly outside Papua New Guinea. In certain restricted circumstances they authorise the Chief Collector to determine the quantum and the source of profits. In order to preclude an overlap and consequent double taxation, Section 197G provides that any consideration, income or expenditure dealt with under Section 196D will not be taken into account in applying Sections 60 to 65. Moreover, subsection 197E(9) excludes the deemed source and profit provisions of Sections 60 to 65 from consideration by the Chief Collector in making a determination as to source or apportionment under Section 197E. Also excluded, by subsection 197B(2), are the provisions of Section 53A, which allows the deeming of an arm's length price in a non-arm's length purchase of trading stock.

In following so closely the Australian transfer pricing legislation, Papua New Guinea has made a curious omission. A comprehensive apparatus has been established for the application of an arm's length standard to non-arm's length international transactions, which may be employed in the assessment of a taxpayer's income. There is even a special objection and appeals procedure for determination of compensating adjustments under Section 197F. But what of a situation where the assessment for the year has been made, before the transfer pricing has been identified and Section 197D applied?

Section 232 limits the power of the Chief Collector to amend assessments which have already been made. If a taxpayer has made a full and true disclosure of all material facts necessary for his assessment (which may be in question in a transfer pricing situation) an amendment to increase the tax liability may be made only within 3 years of the tax payment date under the original assessment. Where there has not been full and true disclosure, but the case is not one of fraud or evasion, the time limit is 6 years.

In order to avoid the problem with time limits in amending assessments to reflect transfer pricing adjustments, the Australian Income Tax Assessment Act was amended to exclude such assessments from the time limits. However, the Papua New Guinea Income Tax Act has not been so amended. Therefore, in some cases the Chief Collector may be estopped from amending an assessment unless Parliament remedies the situation.

It is apparent that Papua New Guinea is now equipped with a comprehensive legislative framework with which to counteract transfer pricing by its taxpayers. However, there remains considerable doubt as to the effectiveness of the legislation in the particular context of Papua New Guinea. Transfer pricing is a practice with substantial political and economic implications in this trade-dominated economy. Whatever the tax legislation, any taxpayer indulging in such practices runs the risk of destroying his ability to do business in Papua New Guinea, if his actions become known to the authorities. This is the real disincentive. However, its effectiveness has depended, and will continue to depend, on the ability of the authorities, including the Taxation Office, Bureau of Customs, and Controller of Foreign Exchange, to identify a transfer pricing situation, and to know what the arm's length consideration should be. This problem is far from solution in the most developed countries. It is doubtful whether the limited resources and expertise available in Papua New Guinea will be able to do more than identify a random few of those prepared to involve themselves in these practices.

SPECIFIC GAINS TAX

Papua New Guinea is a developing country with an open, free enterprise economy, heavily dependent on foreign investment for the large task of development before it. In these circumstances, it has adopted a cautious approach to the taxation of capital. The absence of a tax on undistributed profits and of a general capital gains tax enabled investors in companies, in particular those terminating their involvement with Papua New Guinea, to realise accumulated profits by sale of a continuing business. It is relevant to note that the potential income tax liability remained, to crystallise when profits were eventually distributed by way of dividend or on liquidation.

This situation was formerly relatively easy to exploit in the more liberal tax regime which applied before independence, particularly with rather ineffective legislation governing non-income benefits from private companies. Various steps were taken to rectify this situation. Amongst these was the general anti-avoidance legislation now forming Section 361 of the Income Tax Act, which is based on Section 99 of the Income Tax Act 1976 of New Zealand. Section 361(5), in particular, provided for taxation of the consideration for sale of shares, to the extent to which that consideration represented income which the vendor might be expected to have derived. However, subsection 361(5) applies only where the sale of shares forms part of a tax avoidance arrangement. An attempt to apply the provision to a more straightforward share sale failed before the National Court (Chief Collector of Taxes v. Folkes (1982) PNGTC 45001).

The response to this failure to apply Section 361(5) to what was perceived as a tax avoidance arrangement was to enact new legislation effective from 9 November 1982, taxing sales of shares by holders of material interests in a company. This tax, which combines features of an undistributed profits tax and of a capital gains tax, is known as "specific gains tax" and is described below.

The legislation is inserted as Division III.14B, Sections 196G to 196O, of the Income Tax Act. The basic proposition, given in Section 196H, is that a disposal of shares by a person who holds or has held 20% or more of the issued capital of the relative company is liable to specific gains tax on the consideration receivable for that disposal. The "gain" is assessed on the vendor. The rate of specific gains tax, declared in the Income Tax (Specific Gains Tax) (Rates) Act 1982, is 15%. This rate, almost certainly by design, is identical with the rate of dividend (withholding) tax.

This simple formula is qualified and elaborated in the rest of Division 14B. Most significantly, the "taxable gain" is limited by Section 196I to the lesser of:

(a) the excess of disposal consideration over the paid-up value of the shares; or
(b) the dividend entitlement attaching to the shares assuming all undistributed profits were to be distributed. For this purpose, undistributed profits are defined as total taxable income from incorporation to date of the share disposal, as reduced by income taxes paid or payable, dividends paid or deemed to have been paid and any amount previously assessed to specific gains tax by reference to undistributed profits.

It will be noted that no account is taken of cost of shares in excess of paid-up capital. Moreover, a sale by one shareholder, taxed by reference to undistributed profits, could reduce the taxable gain assessed on a subsequent disposal of other shares by another shareholder, which concept has little basis in logic.

The definition of vendor in Section 196G includes any person who sells or otherwise disposes of shares. It also includes a group of persons "(being persons as defined in Part III.7B)". In fact, Part III.7B contains no definition of "persons" or "person". However, it does define, in Section 144, "associated person", which is presumably the definition referred to in Section 196G. An associated person means:

(a) two companies with substantially the same shareholders or are under the control of the same persons;
(b) a company and any of its shareholders;
(c) any two relatives (spouse, parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant, adopted child, and their spouses);
(d) a partnership and any associated person of a partner;
(e) a trust estate and any associated person of a trustee, settlor or beneficiary.

In a situation where a holding exceeding 20% of issued capital is held by associated holders with individual holdings of less than 20%, then a disposal by one of those shareholders presumably gives rise to an assessment on the associated holders jointly, since it is the "group of persons" which is the assessable vendor for the purposes of Sections 196G and 196H. This raises questions as to whether the liability is joint and several, and as to the correct mode of service of the assessment. It is certainly a feature unique in the Income Tax Act, and almost certainly unintended.

The definition of associated person itself gives rise to difficulties, since it is expressed in terms of one to one relationships. For example, the shareholdings in a company are:

A	15%
B, A's wife	4%
C, a company wholly owned by B	81%

On a disposal by A, it would appear that C would not be an associated person although B is associated with both A and C, so that no specific gains tax charge would arise.

The taxable gain is calculated by reference to actual consideration. There is no provision for deeming consideration in a non-arm's length sale or other disposition. The transfer pricing provisions of Section 197D, outlined above, could deem an arm's length consideration if the disposal constituted an international agreement. However, the apportionment and sourcing powers in Section 197E would not be available to the Chief Collector, since that section applies only to income and expenditure, and not to taxable gains. The tax does not apply to share transactions other than disposals, such as allotments or redemptions, nor to interests in shares, such as options. It applies to shareholders only, and does not look through to the beneficial owners.

An agreement to avoid specific gains tax is within the ambit of the anti-avoidance provisions of Section 361. Subsection 361(5), relating to share disposals (see under transfer pricing above), is specifically excluded from operating by subsection 361(6) where specific gains tax is paid by reference to undistributed profits (as opposed to the sale consideration). However, the general anti-avoidance provision of subsection 361(2) remains applicable. Any arrangement caught by section 361 can be deemed to be void for tax purposes. It should be noted, however, that there must still be a taxable disposal: Section 361 cannot deem a transaction which has not in fact occurred.

The mechanics of assessment and collection are likely to prove effective in ensuring that specific gains tax is not evaded. A person acquiring shares from a vendor liable to specific gains tax is required to notify the Chief Collector of the transaction within 14 days of the date of sale, ascertain from the Chief Collector the amount of tax payable and pay that tax to the Chief Collector. A purchaser could have difficulties in establishing whether the vendor has associated shareholders sufficient to exceed the 20% exemption limit. Although the purchaser may deduct and must pay the specific gains tax, the assessment is on the vendor, who must pay any balance of tax due. If a taxable gain is also included in an income tax assessment, for example under the anti-avoidance provisions, the relative specific gains tax is creditable in that assessment.

The general rights to objection and appeal in Sections 245 to 258 are granted to "a taxpayer", who is defined in Section 4(1) as a person deriving income. It would therefore seem that a person with a taxable gain but not deriving income has no rights of objection or appeal against a specific gains tax assessment.

Specific gains tax has no territorial limitation. Theoretically, a sale by a resident of France of shares in a Japanese company to a resident of Pakistan would be liable to Papua New Guinea specific gains tax. However, undistributed profits are defined by reference to income taxed under the Papua New Guinea Income Tax Act. Consequently, the scope of the tax is limited to resident companies and the Papua New Guinea taxable profits of a non-resident company. It will be interesting to see whether the Chief Collector seeks to tax disposals of shares in non-resident companies with a present or former branch in Papua New Guinea, should he become aware of any such transaction.

It is apparent from the foregoing that the specific gains tax legislation contains many inconsistencies, lacunae and difficulties in interpretation which can be expected to greatly impede its operation, unless they are resolved by amending legislation. But perhaps the greatest difficulty with specific gains tax is that it is so specific as to be capricious. The tax is based on the undistributed profits of companies, but is borne by the vendor, not the company, and is not creditable against the eventual dividend (withholding) tax liability when profits are distributed. It is wayward in its application to groups of companies, since the amount of a specific gains tax charge depends not on the value of the group, but on where, in the group structure, the undistributed profit lies. Specific gains tax may well act as a brake on the growth of business involvement by Papua New Guineans, which the tax and regulatory environment does much to promote. The tax may hinder the rationalisation of businesses by Papua New Guineans and others, since profits will bear an additional 15% tax on top of income and dividend (withholding) taxes of up to 50%. The tax could well divert investment capital away from productive business into the already over-active and highly inflationary real estate market.

FOREIGN CONTRACTORS

Sections 196A to 196F of the Income Tax Act apply to non-residents of Papua New Guinea who undertake a contract for the installation, maintenance or use in Papua New Guinea of substantial equipment or machinery; construction or civil engineering works in Papua New Guinea; and for professional services or services as an adviser, consultant or manager in Papua New Guinea. Contracts for the labour of the contractor are excluded if they fall within the charge to salary or wages tax, which would usually be the case. A possible area of overlap with the royalty provisions has been clarified by the Chief Collector in a recent circular: payments for a right to use equipment (rentals, for example) or existing knowledge are taxed as royalties; contracts for services performed within Papua New Guinea are taxed under the foreign contractor provisions. These provisions cover three areas: source of income; basis of taxation; and collection of tax.

All payments under a contract which contains an element which falls within the provisions are deemed to have a source in and are therefore taxable in Papua New Guinea. A strict application of this principle could result in the assessment in Papua New Guinea of income regarded as having a domestic source by the contractor's home country, and therefore ineligible for foreign tax credit. The resulting double taxation could be sufficient to deter many contractors from operating in Papua New Guinea. Fortunately, this situation does not arise in practice, as is explained below.

Section 196D provides that the taxable income from a contract within the provisions will be either 25% of the gross contract income, or the actual net profit (or loss) if such can be established to the Chief Collector's satisfaction. A corporate foreign contractor, therefore, in practice has a choice between a tax at 12% of gross contract receipts (25% × 48% non-resident corporate rate) or at 48% of net taxable income computed in the usual way. Where the net income basis is adopted, the Chief Collector disregards the deemed source provision and allocated contract receipts between Papua New Guinea and foreign sources according to normal concepts, principally to the place of performance of services.

The provisions apply separately to each contract. It is therefore possible to adopt different bases for different contracts and to structure contracts to minimise tax. The Taxation Office might be expected to take an unfavourable view of any blatant exploitation of such opportunities.

The third feature of these provisions concerns arrangements for reporting contracts and collecting tax. Since the legislation was introduced in 1969, it provided in Section 196F that the principal in an affected contract should not make a payment of income within the provisions, or transfer funds out of Papua New Guinea for the purpose of such a payment, until arrangements had been made for the payment of tax to the satisfaction of the Chief Collector. A breach of this requirement rendered the principal liable for the contractor's tax. Despite this provision, there was substantial evasion of tax, particularly in cases where both principal and contractor had only a short-term involvement in Papua New Guinea; or funds for the payment of the contractor were already held offshore and thus not subject to the tax clearance procedures; or where the principal in the contract was a government department or agency.

The authorities have sought to rectify these deficiencies with effect from 9 November 1982 in two ways. Firstly, the principal is now required by the amended Section 196F to provide a copy of an affected contract to the Chief Collector within 14 days of signing. Secondly, the general definition of "person" in Section 4(1) has been extended to include statutory and public authorities, provincial and local governments. This removes doubt as to whether the notification provisions extended to such principals. At least as significant as the legislative amendments is the very obvious effort now being made by the Taxation Office to identify and tax foreign contractors.

DEEMED LIQUIDATION OF DORMANT COMPANIES

Unlike the situation in many countries which have comprehensive capital gains taxation, the undistributed revenue profits of a company are regarded by the Papua New Guinea tax system as retaining their income nature until after they are eventually distributed. Thus, distributions out of revenue reserves in a liquidation are liable to dividend (withholding) tax and, if received by a non-corporate resident, to income tax. The basis of calculation of distributable revenue reserves is not yet settled, but the legislation does refer to distributions "representing" income and amounts "that have been included in the assessable income of the company". There is also a provision, subsection 48 (3A), which taxes distributions "otherwise than by the company" and in connection with the discontinuance of its business otherwise than in the course of a winding-up of the company. Subsection 48(3A) applies in very specific circumstances, is difficult to interpret and has rarely been applied.

The new legislation, effective from 9 November 1982, deems certain dormant companies to be liquidated and therefore triggers charges to dividend (withholding) tax and in some cases income tax. Subsections 48(3C) to

48(3E) apply to resident companies which:

(a) have not lodged a return of income for 3 consecutive years; and
(b) have more than 75% of assets, as disclosed in the last return lodged, located or invested outside Papua New Guinea; and
(c) are not carrying on business in Papua New Guinea. A company is not regarded as carrying on business if its only income is from investments or property, or if the Chief Collector is not satisfied that the purported business is bona fide and carried on for the purpose of earning a profit.

If all three criteria are met, the company is deemed dissolved and the deemed taxable distribution apportioned between the shareholders in the ratio of paid-up share capital.

This legislation appears to have some obvious loopholes. It would not be impossible for a dormant company to acquire a small, but genuine, interest in a bona fide business, and thus prevent the provisions applying. Even more puzzling is the date on which the company is deemed to be liquidated, being the date on which any tax charge arises. This is the later of the commencement of the Section or the third anniversary of lodgement of the last return. This is not stated to refer to the last return prior to commencement of the 3 year non-lodgement period; consequently, a company may have failed to lodge a return for 3 years and thus be caught by the provisions, then recommence lodging returns and indefinitely postpone the tax charge. Of course, a dormant company which, by force of habit, has continued to lodge returns is unaffected by the provisions.

The situation which these provisions attack is an anachronism. It is now most unlikely that a dormant company would obtain exchange control approval to make overseas investments. The companies affected are mostly historical relics of the colonial period, prior to the introduction of exchange controls in 1976.

OVERSEAS INVESTMENT

The deemed liquidation provisions are complemented by the new section 144AB, also effective from 9 November 1982. This section applies to a resident company which discontinues or is in the course of discontinuing its business, or has substantially changed the nature or conduct of its business operations.

If such a company, directly or through an associated person, makes an investment in property outside Papua New Guinea, the amount paid in making the investment is deemed a dividend and apportioned between the shareholders according to paid-up share capital. Property is extremely widely defined to include real and personal property, shares, debentures, securities, loans, choses in action and options.

To avoid a charge on bona fide arm's length transactions in the normal course of business, a company may request a determination by the Chief Collector that the section does not apply. The request must be made within 30 days after making the investment. It is curious that clearance is to be obtained after rather than before the company is committed to the investment. If an actively trading company substantially changes the nature of its business, by adopting new product lines or opening new markets, it is difficult to conceive how the Chief Collector could determine that the section does not apply, when it clearly falls within its terms. Yet it is doubtful whether the legislation is really aimed at charging tax in such circumstances.

As noted above, it is now unusual for a Papua New Guinea company to obtain exchange control approval to make significant investment overseas, except in the course of its trading activities. This section is therefore likely to apply in very few cases indeed.

EXPORT INCENTIVE

Sections 45A to 45H of the Income Tax Act exempt from income tax the taxable income attributable to the increase in export sales by a manufacturer of prescribed products manufactured in Papua New Guinea over the average export sales of the preceding 3 years.

Under the pre-existing legislation, exempt export income absorbed losses on other activities which would otherwise have been available to be carried forward for deduction in future years. From 1 January 1983, by an amendment to subsection 101(1), exempt export income is no longer available to absorb such losses.

STAFF TRAINING

The shortage of skilled manpower is perhaps the most significant single brake on the economic development of Papua New Guinea. The importance placed by the Government on the need to develop local expertise is manifested in many aspects of the regulatory environment. An income tax incentive to staff training is contained in Section 72A of the Income Tax Act.

That section formerly applied only to apprentices registered with the Apprenticeship Board, thereby excluding unindentured trainees, professional students, and many management and technical trainees. The section allowed a special deduction for expenditure in connection with the apprentice's wages and education or prescribed training. The deduction is double the expenditure incurred, but so that the resulting tax saving shall not exceed 75% of the expenditure incurred.

With effect from 1 January 1983 the scope of Section 72A is extended to cover indigenous citizens attending full-time training at a Papua New Guinea Government training institute or a prescribed tertiary level place of education. On the other hand, the deduction is now limited to expenditure on the salary or wages of the relevant trainees. This limitation gives rise to an interpretational problem: payments to sponsored student employees are frequently exempt from income tax as scholarship or bursary income; but exempt income is excluded from the general definition of "salary or wages" in Section 4(1) and would therefore not qualify for the deduction. However, it is understood that the Taxation Office will not take this point in bona fide cases.

It is anticipated that, despite the new limitation to salary or wage expenditure, the amended section will provide a very real stimulus to the vocational training of Papua New Guineans. No tertiary education institutions have yet been prescribed in the regulations, but they are expected to include reputable overseas institutions.

INITIAL YEAR ACCELERATED DEPRECIATION

Depreciation for tax purposes of income-producing assets has, in Papua New Guinea, traditionally been set at rates intended to reflect the expected lives of those assets. However, since 1980 there has been a changing list of classes of business and expenditure which qualify for an accelerated depreciation deduction. The deduction is allowed in the year in which the asset is first used or installed and ready for use. With some exceptions for fuel conservation equipment, the deduction is 20% of the cost of assets with a life exceeding 5 years, and is in addition to normal depreciation. The deduction reduces the depreciated value for future years. By amendment to subsection 73(2), from 9 November 1982, the following classes of business will no longer qualify for accelerated depreciation: financing; insurance; real estate management; business services; community, social and personal services.

PRIMARY PRODUCTION

Much capital expenditure on land for agricultural or plantation use qualifies for an outright deduction, rather than depreciation or amortisation. To the list of such deductions is added, from 1 January 1983, expenditure on the construction or improvement of accommodation for plantation employees earning no more than 20 K (US$24) per week, and excluding the manager's residence.

Given the extremely depressed state of the plantation sector, it is questionable whether many employers will be able to take advantage of this deduction for some time.

CONCLUSION

The income tax amendments arising from the 1983 Budget reveal no signs of a grand strategy, nor is that surprising in these times of economic adversity. There is some tinkering at the periphery of the tax system, tightening up in some vulnerable areas, and further movement in established directions. Only the specific gains tax breaks new ground, and it remains to be seen whether, as the inadequacies and effects of that legislation become apparent, the government will pull back from this tax, or decide to grasp the nettle of a general capital gains or undistributed profits tax.

This budget does illustrate the need for more rigorous standards in drafting income tax legislation. Uncertainties and inconsistencies deprive the public of that stability which is an essential requirement for successful enterprise, and hamper the authorities in efficient collection of the public revenue.

It may be that an opportunity to provide real stimulus to a depressed economy has been allowed to slip by. The effectiveness of tax incentives is controversial; however, the argument which has been advanced, that the country cannot afford such incentives in difficult times, is specious. It is in difficult times that incentives are needed. To provide carefully structured incentives to new investments which would not otherwise exist, and which enlarge the tax base, costs the public revenue nothing.

NEW INCENTIVES FOR COMPANY CAPITALIZATION IN BRAZIL

[Continued from page 301]

6. A legal entity that utilizes the financial credit cannot reduce its equity capital for a period of 5 years as of the date of the increase, under penalty of having to refund the financial credit, plus a monetary correction and default interest and a fine of 50% of the corrected sum.

7. The financial credit should not be included in the determination of the legal entity's taxable income for income tax purposes but should be taken to a specific reserve which may only be used for capitalization or offset of losses.[5] This specific reserve may thus not be distributed as profit or dividend to the partners or shareholders of the company that enjoyed the financial credit.

8. The financial credit is realized by deduction from the corporate tax owned by the company in the financial year (income tax payment year) that corresponds to the base year (year of assessment of taxable income) in which the capitalization was made.[6]

9. The amount of the financial credit is to be expressed in terms of Readjustable National Treasury Bonds (ORTNs) according to the value of the ORTN in the month of the capitalization. Accordingly, if the capital increase was made in April 1983 for an amount of Cr$ 100,000,000 as a result of foreign loans, the financial credit will be Cr$ 10,000,000 (10% of the capital increase). As the ORTN was worth Cr$ 3,588.63 in April 1983, the financial credit will be the equivalent of 2,786.57 ORTNs (Cr$ 10,000,000 divided by 3,588.63). The value of the financial credit will thus be constantly corrected according to the correction index established by the Government each month for the value of the ORTN. The amount of the financial credit will thus be monetarily corrected until the date of its use.[7]

10. If any or all of the financial credit cannot be used because there is no corporate tax payable, the company will be entitled to receive the credit in cash in the case described in 2 above. In the cases of 3 and 4 above, the financial credit can only be used to offset corporate tax payable in the 3 financial years following the base year of the capitalization and may thus not be received in cash.[8]

4. Ordinance No. 13, item I(b).
5. Ordinance No. 69, item 3.
6. Ordinance No. 13, item II.
7. Ordinance No. 13, item III.
8. Ordinance No. 69, item 1.1.

The Abolition of Turnover Tax Borders in the EEC: A Step in Two Different Directions

Commission Proposals on Travellers' Tax-free Allowances and Duty-free Shops

by M.Loughran

I. INTRODUCTION

Within the European Community a common system of tax-free allowances for goods contained in travellers' personal luggage in regard to both intra-Community travel and travel between third countries and the Community has been in force since 1969. Allowances in respect of turnover tax and excise duties were introduced by Directive 69/169 in 1969. In regard to customs duties an allowance scheme was introduced in the same year by Regulation 1544/69. Council Regulation 1818 of 1975 extended the exemptions from customs duties to agricultural levies imposed on agricultural goods under the common agricultural policy. Following a Report issued by the Commission of the European Communities on tax-free allowances in February 1983,[1] the Commission published in April two new draft Directives, the Sixth[2] and Seventh[3] Directives on exemptions from turnover taxes and excise duties in international travel (hereinafter referred to as the Sixth and Seventh Directives). The purpose of this article is to examine the system of exemption from taxes and duties in international travel, to highlight the defects of the system as perceived by the Commission in its Report of February 1983 (hereinafter referred to as the Commission's Report) and to see how far the present proposals go in repairing the defects.

In relation to intra-Community travel, the term tax-free allowance is perhaps a misnomer: the exemption from turnover taxes and excise duties on importation does not, in theory, mean that the intra-Community traveller may purchase goods in a foreign country and import them without paying any tax at all. Rather, the tax-free allowance system, as it applies to intra-Community travel, confers on the traveller the right to import goods, within certain limits and subject to conditions, without payment of importation taxes, it being assumed that the traveller has already paid turnover tax and excise duty in the country of export. The tax-free allowance system as applied to travel between Member States is really, therefore, little more than the application of the destination principle within certain limits. In the Commission's Report of February 1983, it is stated that the "main aim of the common system was to be achieved through the creation for travellers of conditions similar to those obtaining on a domestic market, thus ensuring the elimination of cases of double taxation or non-taxation". In other words, the purpose of the tax-free allowance system as applied to intra-Community travel was, in the Commission's view, to make the existence of the common market a reality for the ordinary citizen by allowing him to cross the border of any Member State without being required to pay further internal taxes in the country of destination on goods contained in personal luggage on which he has already paid internal taxes in the country of origin. This view has remained somewhat controversial, in particular in respect to the implications for duty-free shops in intra-Community travel. The legal provisions relating to tax-free allowances from turnover taxes and excise duties are not entirely clear and have been the subject of varying interpretations by various Member States.[4] All of these interpretations can lay equal claim to being the correct one. It is for this reason that the Commission has decided to issue a proposal for a Seventh Directive on Tax-Free Allowances to clarify some of the legal ambiguities involved.

Given that the Commission views the tax-free allowances for intra-Community travellers as a means merely of facilitating the personal export and import of merchandise by Community citizens, it is not surprising that it should wish to increase the exemption limits as far as possible so as to maximise the positive effects of this system in making the common market a reality for the ordinary citizen. Attempts to increase exemption limits or to otherwise broaden the scheme and thus render it more complete have as a general rule been resisted by the

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1. See Report from the Commission to the Council on tax-free allowances benefiting individuals. COM (83) 47 final of 4 February 1983 (hereinafter "Commission Report").
2. See Proposal for a Sixth Council Directive amending Directive 69/169 on exemption from turnover tax and excise duty on imports in international travel. COM (83) 117 final of 6 April 1983.
3. See Proposal for a Seventh Council Directive amending Directive 69/169 on exemption from turnover tax and excise duty on imports in international travel. COM (83) 166 final/2 of 18 April 1983.
4. See Explanatory Memorandum to the Proposal for a Seventh Council Directive amending Directive 69/169 on Exemptions from Turnover Tax and Excise Duty on Imports in International Travel. COM (83) 166 final/2, paragraph 1.

European Council of Ministers.[5] It can be readily understood that those Member States with relatively high prices do not have an interest in facilitating their citizens' ability in buying goods abroad where the importation of such goods is completely free of import taxes. For Member States with high prices this will represent a substantial loss of revenue. Conversely for those with relatively low prices, there will be a correlative gain.

Quite recently these exemption limits for intra-Community travellers were raised to 210 ECU with effect from 1 January 1983.[6] The Commission has subsequently proposed further measures to increase the real value of allowances in its proposed Sixth Directive. These measures take the form of a multiannual programme of increases up to 1987 and a semi-automatic procedure for increasing allowances, to take account of changes in exchange rates.

On the other hand, the tax-free allowance system as it applied to travel between third states and the Community confers a true tax exemption and is not aimed at relieving double taxation or at preventing non-taxation. The function of this system, on the Community level, was to provide for uniform treatment of travellers from third states so that the European Community could be identified as one single customs territory.[7] On a national level, exemptions from customs duties and Regulation 1818/75 represent a fulfillment of each Member State's obligations under the New York Convention of 1954, under which the Contracting Parties (including all 10 Member States) undertook, inter alia, to exempt from import duties and taxes goods which are for personal use only and which are contained in travellers' personal luggage. The underlying purpose of this exemption is, of course, to simplify the work of the customs authorities who would otherwise have to assess and charge duty on small quantities of goods contained in travellers' luggage and which are of small dutiable value.[8]

II. THE PRESENT SYSTEM

A. General

The tax-free allowances in respect of customs duties and in respect of turnover taxes and excise duties and the conditions to be fulfilled to obtain them are set out in two separate series of legislative instruments. In regard to turnover taxes and excise duties the basic law is set out in Directive 69/169. This has been amended several times, principally by Directives 72/230; 78/1032 and 82/443.[9] Two further amendments are proposed in the recently issued Sixth and Seventh Directives discussed below. In regard to tax-free allowances from customs duties, the basic Community instrument is Regulation 3061/78.[10] No change in these allowances or in the conditions to be fulfilled to qualify for them are presently proposed. They are mentioned here primarily so as to give a complete picture of the tax-free allowance system as presently operated and also because they have a bearing on the Butter Boats Case[11] and the proposal for a Seventh Directive discussed below.

B. Tax-free allowances in respect of turnover tax and excise duties

Council Directive 69/169 sets out the limits and the conditions for the application of tax-free allowances in relation to turnover taxes and excise duties. Two different systems operated according to whether the goods belong to a traveller coming from outside the European Community or from within the Community. It should be noted that the distinction between the two categories is based on the place of origin of the traveller. The fact that the goods originate within or outside Community territory is irrelevant. In both cases there are both value and quantitative allowances.

(1) Travel from a third country to the Community

(a) Value allowances

Exemption from turnover tax and excise duty on importation is available to travellers entering the community from third countries in respect of goods contained in their personal luggage, provided that:
(1) the goods are non-commercial in character;
(2) the value of the goods does not exceed 45 ECU per person.

Member States have a discretion to reduce this allowance to 23 ECU for travellers under 15 years. Where the total amount imported by any person exceeds the value of his allowance, exemptions may still be granted for single items whose value is within the limit.

Importations are regarded as being non-commercial if they take place only occasionally and consist of goods intended for personal or family use or as presents. In determining whether a particular importation is non-commercial the nature and quantity of goods imported will be taken into account. Personal luggage is defined as the luggage which a traveller submits to the customs authorities either at the time of arrival or later, provided that such luggage was registered as accompanied luggage. Portable fuel containers are specifically excluded from the definition.

In the case of frontier zone workers, frontier zone residents and the crews of ships, airplanes and trains used in international transport, Member States are permitted to set lower exemption limits, at their discretion. All

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5. See Commission Report, paragraph 6, where the Commission laments the general slow-down in the development of the common tax-free allowance system. It attributes this deceleration to the divergence in price levels in the various Member States and to the reluctance of Member States to deal with the "general problem of non-taxation", i.e. the sale of goods tax-free in one Member State and their importation tax-free into another. See also the same Report at paragraph 21.
6. One ECU is equal to approximately US$0.911585 (*Financial Times*, 18 May 1983).
7. Commission Report at page 2, paragraph 5.
8. See the second recital to Regulation 1544/69. Official Journal of the European Communities (hereinafter "O.J.") No. L 191, 5-8-1969, p. 1.
9. Directive 69/169, OJ No. L 133, 4-6-1969, p. 6.
Directive 72/230, OJ No. L 139, 17-6-1972, p. 28.
Directive 78/1032, OJ No. L 366, 28-12-1978, p. 28.
Directive 82/443, OJ No. L 206, 14-7-1982, p. 35.
10. Council Regulation 1544/69, OJ No. L 191, 5-8-1969, p. 1.
Council Regulation 3061/78, OJ No. L 366, 19-12-1978, p. 3.
11. Revue Handelsgesellschaft Nord mbH v. Hauptzollamt Kiel, Case 158/80 of 7 July 1981, European Court Reports, p. 1827.

Member States avail of this opportunity to reduce the exdemption limits.[12] A frontier zone is an area of territory within 15 Km. of the border of a Member State.

In calculating the value of goods in personal luggage for the purposes of applying the tax-free allowance, personal effects which had been temporarily exported, i.e. personal effects which belonged to the traveller at the beginning of his journey and which he takes with him, are disregarded. Thus only newly-purchased goods will be taken into account in assessing whether the exemption limits have been reached. Goods which are subject to quantitative allowances are also disregarded for the purposes of calculating whether the 45 ECU limit has been reached.

(b) Quantitative allowances

The quantitative allowances granted to travellers coming from third countries are lower than those applicable in intra-Community travel. These allowances are set out in an Appendix to this article. Member States may, however, set different limits for travellers who reside outside the European Community although if different limits are set the total quantity of goods exempted may not exceed intra-Community limits.

There are three restrictions on these allowances one of which is compulsory and two are discretionary:

(1) The allowance for tobacco and alcohol is not available to persons under 17 years. The allowance for coffee is not available to persons under 15 years.
(2) Member States may restrict allowances in relation to frontier zone workers, frontier zone residents and the crews of ships, airplanes and trains used in international transport.
(3) There is also a discretion to reduce the limits in respect of tobacco and coffee. At present only Germany applies this restriction.

(2) Travel between Member States

(a) Value allowances

Exemption from turnover tax and excise duties on importation is available to travellers entering one Member State from another, in respect of goods contained in travellers' personal luggage, provided that the goods:

(1) are in free circulation within the Community. Goods of Community origin are automatically in free circulation since they are entitled to free movement within the Community. Goods coming from third states are in free circulation as soon as the appropriate customs duties and agricultural levies have been paid (and are not subsequently refunded) and import formalities have been complied with;[13]
(2) have been acquired subject to the general rules governing taxation on the domestic market of one of the Member States;
(3) have no commercial character;
(4) their value does not exceed 210 ECU.[14]

Member States may reduce this allowance to 60 ECU for travellers under 15 years. The definitions of personal luggage and "commercial character" mentioned above apply also to inter-Community travel. The provisions applicable to travel from third countries permitting the exemption of single items whose value does not exceed the limit, even though the total value of the items imported does exceed the exemption limit, apply also to intra-Community travel. Personal effects which have been temporarily exported and goods which are subject to the quantitative allowances are disregarded for the purpose of determining whether the total value of imports exceeds the allowance limits. For frontier zone workers, frontier zone residents and the crews of ships, airplanes and international trains, the exemption limit may be reduced to a minimum of 21 ECU.

A further condition applies to the intra-Community allowance where the travel either involves transit through the territory of a third country or begins in a part of the territory of another Member State in which turnover tax or excise duty is not charged, i.e. a tax-free zone.[15] In such cases the traveller is required to *prove* that the goods have been acquired subject to the general conditions governing taxation in the Member State of origin and that the goods do not qualify for any refund of turnover tax or duty. If the traveller fails to prove this, the third country allowances, which are lower, will apply.

(b) Quantitative allowances

Quantitative allowances are granted in respect of tobacco products, alcohol, perfumes, coffee and tea. The allowances applicable to intra-Community travel are substantially higher than those applicable to travel from third countries to the Community.[16] Both series of allowances are set out in the Appendix. These limits may be superseded by national provisions setting different exemption limits for persons not resident in the Community. If this option is availed of the individual limits may be reduced or increased but the total value of the goods thereby exempted may not exceed the intra-Community limits.

As in the case of travel from third states to the Community, there are various restrictions on these allowances as follows:

(1) Persons under 17 years may not benefit from the allowances for alcohol and tobacco. The allowance for coffee is restricted to persons over 15 years.
(2) Allowances for frontier zone workers, frontier zone residents and the crews of aircraft, ships and international trains may be restricted to one tenth of the normal allowance.
(3) Allowances for members of the armed forces of a Member State, including civilian personnel and their spouses and dependent children, stationed in another Member State, may be restricted.
(4) Raw or semi-finished gold may be excluded from the benefit of the allowances.

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12. See Commission Report at paragraph 13.
13. E.E.C. Treaty, Articles 9 and 10.
14. It should be noted that Ireland and Denmark are authorised to derogate temporarily from the normal exemption limits. In the case of Denmark the exemption limit will remain 180 ECU until 31 December 1983 (Art. 3(1) of Directive 82/443). In the case of Ireland a reduced limit of 77 ECU will apply until 31 December 1983 (Art. 5(1) of Directive 78/1032).
15. Greenland or Heligoland, for example.
16. Denmark is authorised to apply certain reduced allowances to Danish residents who have remained abroad for less than 48 hours. See Directive 77/800, OJ No. L 336, 26-12-1977.

(3) The conversion of value allowances into national currencies

Value allowances are of course expressed in terms of ECU. These are converted by each Member State into national currencies on the basis of rates of exchange applicable on the first working day of October each year. The amount of the allowance expressed in national currency thus determined applies during the following calendar year. Where the newly calculated allowance differs by less than 5% from the allowance of the previous year, Member States may continue to apply the old amount.

(4) Remission of tax on imports

Since the purpose of the tax-free allowance scheme for intra-Community travel is to prevent either double taxation or non-taxation,[17] the scheme would not have been complete without regulation of the remission or non-remission as circumstances required of tax in the exporting country. Accordingly, Directive 69/169 provides that where the goods contained in travellers' personal luggage exceed the exemption limits, the exporting Member State is required to refund the turnover tax paid on the excess. Conversely, where the goods contained in travellers' personal luggage are within the exemption limits the exporting Member State is prohibited from refunding any tax paid. Thus turnover tax will be paid once only, although in the case where the goods exceed the exemption limits, effectively payment of turnover tax will be divided between the importing and exporting states. The tax due on the value or quantity of the goods up to the exemption limits will be paid in the exporting country. The tax due on the excess will be paid in both countries but will be refunded by the exporting Member State.

There are 5 important caveats to this system which should be noted:

(1) The requirement to remit tax on the excess over the exemption limits applies only in the case of travellers who are domiciled, habitually resident or employed in a Member State. In other cases Member States are quite free to determine the amount of remission and the conditions for its application.

(2) The prohibition on remission of tax applies only in the case of travellers who are domiciled, habitually resident or employed in a Member State. Thus, for non-Community residents a Member State may grant a full refund of turnover tax on the export of the goods as part of a traveller's personal luggage, even though the importing non-Member State also grants an exemption from turnover tax on the importation of the goods. Evidently the Community is not concerned with this kind of non-taxation.

(3) Member States have a discretion to exclude their own residents from the scheme providing for remission of tax on the amount by which the goods exceed exemption limits. Here the object is to prevent tax evasion. Most Member States, with the exception of Luxembourg and the Netherlands, avail of this option.[18]

(4) No remission may be granted in respect of excise duty. Thus, in a case where the exemption limits are exceeded, there is no relief from double taxation.

(5) The obligation to grant tax refunds on the retail sale of goods sold for export is made "without prejudice to rules relating to sales made at airport shops under customs control and on board aircraft". Although the precise purport of this caveat is not entirely clear, it would seem that its purpose is simply to remove from the ambit of the tax remission system all sales made in duty-free shops.[19] Since such sales are made free of VAT and excise duty, the question of refund of tax does not arise.[20]

With the exception of Ireland, all Member States operate a tax remission scheme which is more or less in accordance with Directive 69/169 as amended. Ireland does not operate such a scheme and is therefore acting in violation of its Community obligations. As regards the other Member States, none grants remission of tax on the basis of Ireland's and Denmark's lower exemption limits.

III. THE PROBLEM AREAS AND THE PROPOSED CHANGES

In its Report on tax-free allowances of February 1983, the Commission identifies 5 areas in the system where improvements could be made. These are:

A. the maintenance of the real value of value allowances;
B. the conversion of value allowances into national currencies;
C. the quantitative allowances;
D. the remission of tax system;
E. duty-free shops.

The draft Sixth and Seventh Directives contain proposals for improvements in all of the areas mentioned above. It is proposed to deal with each of these areas in turn and to discuss both the perceived problems and the proposals for solving them contained in the two Directives recently issued by the Commission.

A. The maintenance of the real value of value allowances

(1) Intra-Community allowances

The problem here is relatively straightforward: inflation erodes the value of allowances in real terms. The average annual Community increase in the consumer price index, in the period from 1979 to 1982, was well in excess of 10%.[21] The effect is that the real value of the intra-Community allowances had fallen by 58% by the end of 1981 compared with those obtaining on 1 January 1979. The increase effected on 1 January 1983 fell short by 70 ECU

17. See fourth recital to Council Directive 69/169 and Commission Report at paragraph 5.
18. See Commission Report at paragraph 16.
19. See S. Crosby: "The Butter-Boats Case – Implications for Duty-Free Shops", 1982 *European Law Review* at p. 312. It has been argued that the purpose of this caveat is to prohibit the granting of exemptions from import taxes in respect of goods purchased in duty-free shops.
20. See Lutz in *Neue Juristische Wochenschrift* (Munich) of 10 March 1982.
21. In 1979 the average annual Community increase in the consumer price index was 10.2%. In 1980, the figure was 14.1% and for 1981 it was 12.6%. See Commission Report at paragraph 24.

of the amount required to maintain the purchasing power of the value allowance which applied 4 years earlier.

But for the Commission, mere maintenance of the real value of exemption limits is not enough. In addition it wishes to bring about real increases in all the exemption limits. This is in accordance with its policy of expansion of the whole tax-free allowance system so as to achieve a complete abolition of turnover tax borders.[22] The aim is to make the common market a reality for the ordinary citizen who wishes to bring home goods purchased abroad without having to pay value-added tax twice and without having to go through cumbersome and complicated procedures to obtain a refund of tax paid abroad. Some Member States have in the past shown a reluctance to accede to the Commission's proposals for increases in allowances. The main reason for this is that those Member States with high prices fear a gradual reduction in the tax revenue from indirect taxation due to the exploitation by its own citizens of high allowance limits so as to purchase cheaply abroad goods which cost more at home. The result would be an increase in tax-free imports and a correlative reduction in domestic sales. Member States with relatively low prices would therefore be the ultimate beneficiaries of any substantial opening up of tax frontiers. The Commission counters this argument by pointing out that an overall shift in sales levels from high price countries to low price countries will rarely occur in practice because generally no country enjoys comparatively low price levels across the entire spectrum of transportable commodities. Thus there is a swings and roundabout situation and increases in private importation in one sector will be counterbalanced by increases in foreign travellers' exportation in another. Although this proposition seems perfectly reasonable it has unsurprisingly failed to sway those Member States whose currency value vis-à-vis other Member States makes them a most attractive destination for shoppers from strong currency states.

An even more dubious argument advanced by the Commission is that an increase in private imports of goods contained in travellers' personal luggage from low price states will exercise a downward pressure on prices in the importing state and thus combat inflation. No statistical evidence in support of this argument is cited in the Report. It seems unlikely that the level of such travellers' imports would be high enough to have any significant influence on the importing country's rate of inflation.

In order to effect real increases in the value of the value allowances, the Commission proposes in the Sixth Directive a multiannual programme of increases extending over a period of 4 years. If the proposal is adopted the value allowance would increase annually from 280 ECU on 1 January 1984 by 40 ECU so that by 1 January 1987 it would have reached 400 ECU. The Commission also proposes a gradual phasing out of the special allowance limits for travellers under 15 years. Multiannual programmes for increases in allowances have been proposed by the Commission twice before[23] and on both occasions were rejected by the Council.[24]

(2) Third country allowances

The considerations motivating the desire to increase intra-Community travel allowances do not of course apply to allowances granted on importations of goods contained in the luggage of travellers coming from third countries. Here the level of allowances is dictated largely by international obligations. Small increases in third country allowances were made at the beginning of 1982 and although recent increases in the value of the dollar mean that the Community limit now falls short of the limit of $50 which it is obliged to grant under the Customs Co-operation Council, no proposals to increase this limit have been put forward by the Commission.[25]

B. The conversion of allowances into national currencies

In general it seems that the system for conversion of value allowances into national currencies, as described above, works satisfactorily. However, two minor problems are identified in the Commission's Report:

(1) A situation of double taxation or of non-taxation may arise where, during the course of the calendar year, the currency of a Member State ("A") appreciates against that of another Member State ("B"). This means that goods which are marginally within the tax-free allowance, expressed in Member State A's currency, may be marginally outside the tax-free allowance expressed in the currency of Member State B. The goods will not qualify for tax remission in country A, since they are within the value limit, but will be taxed in country B since they are outside the value allowance expressed in B's currency. The reverse situation of non-taxation is also theoretically possible where the currency of country A depreciates against that of country B. However, the requirement of endorsement of the invoice by the authorities of the country of importation, as a condition for obtaining a tax refund, will in practice prevent the traveller from avoiding tax completely. To remedy this situation the Commission proposes in its draft Sixth Directive a semi-automatic procedure of adjustment of allowances to take account of such changes in exchange rates. Under this procedure the Commission would have power to "take appropriate measures by way of a decision". The nature of these measures is not specified but presumably the intention is to authorize the Member State whose currency has changed in value to adjust its allowance expressed in terms of national currency so as to reflect the new exchange rates. Clearly this procedure would solve the problem of double taxation of goods whose value falls within the margin of differences in exchange rates. This will be done, however, at the expense of continuity and administrative simplicity which was the purpose of establishing the system of annual adjustments introduced in 1978.

22. See Commission Report at paragraph 4.
23. In 1977 in its Proposal for a Third Council Directive on travellers' tax-free allowances (O.J. no. C 31, 8-2-1977, p. 5) and in 1979 in its amended proposal for a Fifth Council Directive on travellers' tax-free allowances (O.J. no. C 318, 19-12-1979, p. 5).
24. See the Fifth Directive on travellers' tax-free allowances in its adopted form: OJ No. L 206, 14-7-1982.
25. Commission Report at paragraphs 34-37.

(2) A second problem which might theoretically arise but which has so far been avoided is that of the need to reduce a value allowance expressed in national currency, because of the revaluation of that currency against that of the ECU. Reductions in value allowances, as a result of the operation of technical rules, have been rejected as politically undesirable by both Council and Commission and it has been tacitly agreed that where such a reduction appears necessary, the value of the allowance, expressed in terms of ECU, should be correspondingly increased so as to avoid the need for a reduction in a particular national currency. The procedure for adoption of a new value allowance normally spans a period of between 6 and 9 months, during which time the Member State concerned will either have to implement the reduction or act in violation of its obligations under Community law. To avoid this potential dilemma the Commission proposes the introduction of a semi-automatic procedure for increasing the allowance expressed in terms of ECU where it appears from the calculation of the new allowances on October 1 of a particular year that reductions in allowances expressed in national currencies will be necessary. To obviate this necessity the Commission proposes that it should be empowered to increase the ECU allowance automatically subject to a power of objection by the Member States.

C. Quantitative allowances

Specific quantitative allowances for tobacco products, alcohol, perfumes, coffee and tea are provided because of the variations in the rates of excise duty which are applied to these products in the Member States. Since little progress has been made in the field of excise duty harmonization, it is felt that increases in allowances for the main excise duty goods would not be appropriate at present. However, excise duties on coffee and tea are imposed in only a few Member States and, where they are imposed, the levels of duty are relatively low. Accordingly, the Commission proposes in the draft Sixth Directive to phase out quantitative limits for coffee and tea completely. Because of "general considerations in favour of increasing tax-free allowances", the Commission also proposes to increase the limit for still wines from 4 to 6 litres.

D. The remission of tax system

Two practical problems are identified in this area. The first is that the administrative procedures for obtaining a refund are too cumbersome. Some Member States insist on the use of special forms to obtain a refund, and will not simply accept the invoice. Also in some Member States it is necessary to apply for a refund to a central administration whereas in others the trader is allowed to refund the tax direct to the traveller. The second problem is that of long delays experienced in some countries before payment is actually received. To deal with the first of these difficulties the Commission proposes to insert a new clause in Article 6 as follows:

> Where the seller refuses to participate in the procedure for remission of tax provided for in paragraph 2, the traveller may, after completing the formalities laid down in paragraph 4, submit a request for refund to the competent authority in the Member State of export.

In the Explanatory Memorandum which accompanies the proposal, it is explained that only certain traders who specialise in sales for export or who understand the system, such as department stores selling to foreign tourists, are prepared to give refunds of tax direct to the customer. Others refuse to become involved in the system because of the administrative cost. In the latter case the Commission therefore proposes that the traveller apply to the tax authorities of the country of export for a refund. The solution proposed by the Commission in its preliminary Report on this subject[26] was that all traders should be allowed to refund tax direct to the traveller where small amounts were involved. The maximum level would then be fixed by Community directives. It seems unfortunate that in the more formal proposals set out in the proposed Sixth Directive, this alternative is put forward in a much diluted form. To deal with the long delays experienced by some travellers before the refund is paid, the Commission proposes to amend Article 6 of Directive 69/169 so as to oblige Member States to ensure that refunds are paid at the maximum 3 months after receipt of the application from the traveller.

E. The case of duty-free shops

The main problem in this area is that it is quite unclear how far Directive 69/169, as amended, applies to goods purchased in duty-free shops. The lack of clarity in some of the provisions of this directive means that the legality of some of the practices carried on by duty-free shops is open to doubt. In order to examine their legal basis, it is necessary to distinguish between: (1) duty-free sales made in respect of travel between third countries and the Community; and (2) duty-free sales made in respect of intra-Community travel. The legal status of the first type of duty-free sale is not in any doubt, although the European Court of Justice has recently clarified certain ambiguities in relation to the interpretation of certain clauses in Directive 69/169.[27] Goods contained in the personal luggage of travellers entering the Community from third countries are entitled to be admitted free of customs and excise duties and of value-added tax, within certain limits (see Appendix). The exemption in favour of third country goods is not conditional on such goods having been taxed already in the country of export. The circumstances of purchase by the traveller entering the Community from a third State are irrelevant therefore to the question of exemption and the traveller will be entitled to import goods contained in his luggage tax and duty-free regardless of whether or not the goods were purchased in a duty-free shop. Goods contained in travellers' personal luggage which originate in a third country but which are in free circulation within the Community are also entitled to enter a Member State from another Member State free of turnover tax and excise

26. Commission Report at paragraph 56.
27. Rewe Handelsgesellschaft Nord mbH v. Hauptzollamt Kiel, cited ibid. at note 11.

duty. The term free circulation, however, means, inter alia, that customs duties or agricultural levies due when the goods first entered the Community have been paid. Exemption for third state goods from import taxes in intra-Community travel is therefore dependent upon a waiver of the exemption from customs duties granted on the original importation into the Community. Sales of third country goods free of customs duties and agricultural levies to travellers in intra-Community travel is therefore illegal. Goods sold in duty-free shops to travellers leaving a Member State for a non-Member State are normally made free of turnover tax and excise duties in accordance with the destination principle and such sales are outside the scope of Directive 69/169.

The legality of duty-free sales made in respect of intra-Community travel is less clear. The system of duty-free sales as it presently operates in most Member States results in a situation of non-taxation of goods purchased in duty-free shops and imported into another Member State, provided their value and quantity is within the intra-Community allowances. In view of the fact that the main purpose of the tax-free allowance system is to avoid a situation of "double taxation without leading to an absence of taxation",[28] the legality of the duty-free practice in relation to intra-Community sales is somewhat dubious. This non-taxation is achieved through an exemption from tax and duty granted at two different stages: first there is a duty-free sale and secondly there is an exemption from tax and duties granted upon importation. In order to examine the legality of the duty-free system as it applies to intra-Community travel, it is necessary to consider the legal basis for granting each of these exemptions, the cumulative effect of which is that there is an absence of taxation contrary to the declared purpose of the Community's tax-free allowance scheme.

Sales made in duty-free shops to intra-Community travellers are generally exempt from VAT, excise duty and customs duty. Exemption from VAT is granted by virtue of the goods being sold for export.[29] The purchaser buys the goods upon production of proof that he is about to leave the country and is therefore about to export the goods. Sales made in duty-free shops to intra-Community travellers are exempt from excise duties not by virtue of Community legislation but rather by virtue of provisions of national law.[30] The legal basis for the exemption from customs duties granted to travellers journeying between Member States in respect of goods which are in free circulation is found in Articles 9-28 of the EEC Treaty establishing the customs union.

Clearly the legality of the exemption from customs duties is not here in question: the compatibility of the exemptions from value added tax and excise duty with the provisions of Directive 69/169, and in particular Article 6 thereof, is however, less clear. Article 6(1) of Directive 69/169 provides as follows: "Member States shall take appropriate measures to avoid remission of tax being granted for deliveries to travellers whose domicile, habitual residence, or place of work is situated in a Member State and whose benefit from the arrangement is provided for in this Directive." Clearly, Member States are prohibited by Article 6(1) from granting remissions of tax on export in respect of goods which subsequently qualify for exemption from tax upon importation. Article 6(2) requires Member States to grant remissions of tax on the amount by which the goods exceed the intra-Community allowances. This clause, however, contains a reservation in favour of duty-free shops as follows: "Without prejudice to rules relating to sales made at airport shops under customs control and on board aircraft, Member States shall . . .". The exact meaning of this reservation is the subject of some controversy. Some Member States have argued that the reservation contained in Article 6(2) authorizes the duty-free system by bringing duty-free goods outside the scope of the Directive altogether.[31] The Commission implicitly disagrees with this interpretation, pointing out that there is no such reservation in Article 6(1).[32] Some writers have interpreted the reservation to mean exactly the opposite, i.e. that it prohibits the granting of exemption from import taxes and duties of goods purchased in duty-free shops in another Member State.[33] Others have argued that the reservation neither authorizes nor prohibits duty-free shops but simply confirms the fact that the tax remission scheme does not apply to duty-free sales since such sales are made free of tax anyway.[34]

The legal basis for the granting of exemptions from turnover taxes and excise duties for duty-free goods on importation is ostensibly Directive 69/169. However, the exemption provided by this Directive for goods contained in the luggage of intra-Community travellers applies only if certain conditions are satisfied. One of these is that the goods "have been acquired subject to the general rules governing taxation on the domestic market of one of the Member States". The exact purport of this condition is not entirely clear. In the view of the Commission this condition disqualifies goods bought in duty-free shops from the benefit of the exemption from import taxes provided in Article 2 of the Directive, since they have not been "acquired subject to normal tax conditions on the domestic market of one of the Member States".[35] The practice of allowing duty-free goods to move from one Member State to another without payment of tax was therefore illegal.

An alternative view is that the provisions of Articles 2(4) and 4(4) apply by analogy to the case of duty-free goods. These articles provide that where an intra-Community journey involves transit through a third country or begins in a part of a Member State where turnover tax or excise duty is not charged, the traveller must prove that the goods were acquired subject to the general conditions governing taxation in the exporting Member State. He must also show that the goods do not qualify for any refunding of turnover tax or of excise duty. If he fails to

28. Fourth recital to Directive 69/169. See also Commission Report at paragraph 5. See also A.J. Easson, Tax Law and Policy in the EEC (London 1980) at paragraphs 246-250.
29. Articles 3 and 16 of Sixth VAT Directive 77/388, OJ No. L 145/1, 1977.
30. Under Community law there is no obligation to impose excise duties. Harmonisation of excise duties to date has taken the form of directives on the method used in assessing excise duties on manufactured tobacco. Harmonisation of excise duties on alcohol, wine and beer remains at the stage of Commission proposals.
31. See Commission Report at paragraph 59.
32. Id.
33. Lutz, cited noted 20.
34. S. Crosby, cited note 19 at p. 322.
35. See Commission Report at paragraph 60.

prove this he may only avail of the lower exemption limits applicable to travel between non-member countries and the Community. If these articles do not apply to duty-free goods, it would seem that goods coming from tax-free zones or which have benefited from a refund of tax on export are in a more advantageous position than duty-free goods falling within Article 2 of the Directive. In the former case, even though the goods have not been taxed at all, they nevertheless benefit from an exemption from importation equal to the value and quantitative limits applicable to travel from third countries to the Community. In the latter case, because the goods have been acquired in a duty-free shop, they do not fulfill the condition requiring that they "have been acquired subject to the general conditions governing taxation . . . of one of the Member States". They do not therefore benefit from any exemption from turnover tax or excise duty on importation whatsoever. And yet goods bought in tax-free zones may in the same circumstances benefit from such an exemption although within reduced limits. This anomaly has prompted some writers to suggest that the provisions of Articles 2(4) and 4(4) providing for these reduced exemption limits must be taken to apply by analogy to the case of duty-free shops.[36] The submission is grounded principally in the desire to avoid an illogical and anomalous distinction being made between tax-free zones and duty-free shops.

Confirmation of this interpretation is implicit in the European Court's judgement in the Butter Boats Case and is explicitly confirmed by the Advocate General in the same case. At issue in this case was, essentially, the legality of the practice of selling goods tax and duty-free on sham voyages from German ports to a point outside German territorial waters. The purpose of these trips was to enable passengers to buy and "import" into Germany goods stocked on board which had benefited from a remission of value added tax and excise duty on "export" and, in the case of agricultural produce, "export" subsidies. In discussing the question of whether such artificially contrived trips could come within the meaning of the term "travel between Member States", Advocate General Capotorti remarked that if such sham voyages did come within the meaning of the term, "the result would be contrary to one of the basic premises on which the exemption in question is founded, namely, that as a general rule goods purchased in one Member State have already borne tax and the exemption from such tax on importation into another State avoids double taxation without leading to an absence of taxation."[37] The court was not so explicit, but it can be inferred from the reply to the sixth question put by the German Court that the Court's interpretation of Directive 69/169 was not very different from that of the Commission. The sixth question put by the German Court asked, in essence, whether goods imported into Germany from a point just outside the territorial waters of a Member State could be regarded as having been imported within the meaning of Directive 69/169. In reply to this question the court stated, inter alia, that "in the case of travel within the Community, where the journey from one Member State to another . . . begins in a part of the territory of the other Member State in which the taxes to which the directive refers are not chargeable on goods which are consumed within that territory, the traveller . . . may enjoy only the more restricted exemption provided for in the case of travel between non-member countries and the community".[38] It seems therefore that duty-free goods, since they are bought "in a part of the territory of another Member State in which turnover tax and excise duty are not chargeable . . .", qualify only for the smaller allowances applicable to third country travel, as provided for in Article 2(4) of Directive 69/169.

Whatever the merits of the above arguments, it now seems that the Commission has itself abandoned any desire to insist on a strict adherence to its own interpretation of the law. Indeed, in the draft Seventh Directive, the Commission has proposed "clarification" of the provisions of Directive 69/169, as amended, in a way which runs contrary to its own previous interpretation of this directive. The new proposals would, if adopted, amend Directive 69/169 so as to exempt duty-free shops from the application of clauses in the Directive which are designed to avoid a situation of non-taxation. Goods purchased in duty-free shops would then qualify for the exemption limits applied to goods coming from third countries. At present these limits apply, as explained above, to goods coming from a tax-free zone in one Member State and entering another Member State. To legalise the duty-free system, exemptions for duty-free goods are proposed in respect of two provisions of the Directive:

(1) the requirement that goods benefiting from the exemption from taxes and duties on importation should have been acquired subject to the general rules governing taxation on the domestic market of a Member State (Article 2(1)).
(2) the prohibition against the remission of tax by the country of export on goods benefiting from the exemption from tax on import (Article 6(1)).

IV. CONCLUSION

The proposals contained in the draft Sixth Directive for the establishment of a 4-year programme of increases in travellers' allowances and for the elimination of quantitative limits for tea and coffee will certainly contribute, albeit in a relatively minor way, towards the total abolition of tax borders within the Community, assuming of course that the proposal is adopted by the Council in its present form. The prospects of this happening are not, judging from the fate of similar proposals made previously, entirely certain. Proposals for similar multiannual programmes and for the abolition of the limits for coffee and tea have been rejected by the Council before now, and there seems little evidence to suggest that a change of circumstances might now prompt a different response.[39]

The proposed Seventh Directive will, if adopted, at last resolve the controversy which has for so long existed in relation to the legal status of duty-free shops. The issuing of this proposal by the Commission represents the culmination of a political evolution from an insistence on the il-

36. S. Crosby, cited note 19 at p. 321.
37. 1982 ECR at p. 1845.
38. 1982 ECR at p. 1836.
39. Commission Report at paragraphs 25 and 51.

legality of duty-free shops in intra-Community travel to a gradual acceptance of the political imperative of allowing them to remain. In 1972 the Commission submitted a proposal to the Council calling for an end to the practice of duty-free sales which was rejected by the Council as politically inappropriate.[40] In 1979 the Commission took a decision not to continue its campaign for the abolition of duty-free shops.[41] This recent proposal for a Seventh Directive is a positive step in favour of maintaining duty-free shops by removing any doubt as to their legal status. This change of mind is due it seems largely to the political sensitivity of the issue and to the Commission's awareness of the effect which the elimination of duty-free shops would have on the Community's popular image. In any event, given the Council's previous rejection of a contrary proposal and the Member States' own insistence on the need to maintain duty-free shops, it seems unlikely that this proposal will meet the same fate as its predecessor.

40. O.J. No. C 113, 28-10-72, p. 15.
41. Tugendhat, C., "The State of Tax Harmonisation in the European Community", *INTERTAX* 1983 p. 11-12.

APPENDIX

	Intra-Community allowances		*Third country allowances*	
	Current limits	*Proposed increases*	*Current limits*	*Proposed increases*
1. General allowance	210 ECU	400 ECU¹ by 1987	45 ECU	–
2. Optional reduced allowance for travellers under 15 years	60 ECU	400 ECU² by 1987	25 ECU	–
3. Drink of an alcoholic strength exceeding 22°	1.5 litres	–	1 litre	–
or Drink of an alcoholic strength not exceeding 22°, sparkling wines	3 litres	–	2 litres	–
and still wines	4 litres	6 litres	2 litres	–
4. Coffee	750 gr.	1000 gr.³	500 gr.	–
5. Coffee extracts and essences	300 gr.	400 gr.³	200 gr.	–
6. Tea	150 gr.	200 gr.³	100 gr.	–
7. Tea extracts and essences	60 gr.	80 gr.	40 gr.	–
8. Tobacco	400 gr.	–	250 gr.	–
9. Cigarettes	300	–	200	–
10. Perfumes	75 gr. or	–	50 gr. or	–
11. Toilet waters	3/8 litres	–	1/4 litre	–

Notes:
1. This increase is to be achieved by an initial increase of 70 ECU on 1-1-1984 and by subsequent annual increases of 40 ECU over the next 3 years.
2. This increase is to be achieved by annual increases varying from 80 to 100 ECU from 1-1-1984 to 1-1-1987.
3. It is proposed to abolish the allowances for coffee and tea and essences thereof from 1 January 1985.

INDIA: Investment by Non-resident Indians

The Indian Government envisages the introduction of a number of important tax concessions for non-resident Indians to encourage them to invest in India. These measures were the subject of a Government Press Note of 22 March 1983 and a Press Release of the Reserve Bank of India of April 1983 which are reproduced in this issue.

GOVERNMENT OF INDIA PRESS NOTE[1]

1. In the Budget for 1983-84, presented to Parliament, the Finance Minister proposed a number of important tax concessions in respect of investment in India by non-residents of Indian origin. These proposals, which would come into effect after the Finance Bill has been passed by Parliament, will enable non-residents to invest in India and earn dividends and interest, etc. with a minimum of procedural formalities.

2. In order to provide a focal point for dealing with proposals and enquiries in respect of financial investments, it has been decided to set up a Special Cell in the Department of Economic Affairs, Ministry of Finance. This Cell will be headed by the "Commissioner for non-resident Indians". The Commissioner will provide one window clearance facilities for non-industrial investment proposals, and will be responsible for coordinating Government of India proposals in respect of financial investments and remittances by non-residents. Proposals involving approval for industrial licence, foreign collaboration and import of capital goods will continue to be handled by the Special Cell in the S.I.A. of the Ministry of Industry.

3. In order to facilitate raising subscriptions to shares and debentures, companies in India will also be allowed to pay reasonable compensation to agents abroad for mobilising remittances in these forms. Such compensation will not be allowed for bank accounts, bank deposits and company deposits. Companies wishing to pay commission under this facility may make their applications to the Reserve Bank of India, Central Office, Bombay through their bankers.

4. The scheme of portfolio investment by non-resident Indians for purchase of shares through stock exchanges up to 1% of the paid-up capital of the company has been in operation for some time. The working of this scheme has been reviewed. It is clarified that this scheme is intended to promote bona fide investments of long duration. It is not intended to encourage speculative transactions. It has, therefore, been decided that purchases of shares under this facility will have to be at the price quoted on the floor of the Stock Exchange and negotiated deals will not be eligible. Further, the scrip so acquired will have to be retained by the non-resident Indian for a minimum period of one year from the date of registration.

5. Investment in the deposits of public limited companies including Government of India undertakings has so far been allowed on the basis of non-repatriation only, i.e. on the basis that income and capital will be retained in rupees in the country. It has now been decided that deposits of three year maturity with public limited companies may be permitted with full repatriation rights. Subject to such companies conforming to the limits and other legal requirements concerning acceptance of deposits, companies wishing to avail of this facility may make their applications to the Reserve Bank of India, Central Office, Exchange Control Department, Bombay.

6. It has been decided that "Hospitals" may also be included as an area open for investment with full repatriation rights. This area will stand included under both the 40% and 74% schemes open to non-resident Indians for investment.

RESERVE BANK OF INDIA PRESS RELEASE[2]

Sub: Investment facilities available to non-residents of Indian nationality/origin and overseas corporate bodies owned to the extent of at least 60% by such non-residents (overseas corporate bodies).

The Bank has announced from time to time since early last year various liberalised investment facilities available to non-residents of Indian nationality/origin (non-resident Indians) and overseas corporate bodies owned to the extent of at least 60% by such non-residents (overseas corporate bodies), on the basis of the decisions taken by the Government of India. A consolidated account of these liberalised facilities is given here:

I. Investment on non-repatriation basis

Non-resident Indians can now invest up to 100% in any partnership/proprietary firms or limited companies (except those dealing in real estate business and agricultural/plan action activities) as also make portfolio investment through stock exchange in shares/debentures of Indian companies without any limit. They can also place funds with firms and companies as deposits subject to the prevailing rules and within the limits prescribed for acceptance of such deposits by companies. Similar investment facilities are also available to overseas corporate bodies except that these bodies are not permitted to invest in partnership/proprietary firms.

II. Investment on repatriation basis

(a) Portfolio investment in shares/debentures

Non-resident Indians and overseas corporate bodies are permitted to make portfolio investment in shares/debentures quoted on Stock Exchanges with full benefits of re-

1. Press Note No. F.25/47/82-FI2T of 22 March 1983.
2. Release 1982-83/231.

patriation of capital invested and income earned thereof provided the investment of each non-resident investor/ overseas corporate body in any one Indian company does not exceed 1% of the paid-up capital of the company in case of shares and 1% of the total issue of each series in case of convertible debentures over and above the 1% shares which such persons can purchase as stated above. They can also purchase non-convertible debentures of any Indian company without any monetary limit on the investment. The shares/debentures purchased under this scheme are to be at the price quoted on stock exchange and the shares so acquired are required to be retained by the investor for a minimum period of one year from the date of registration (please see IV(c) below).

(b) Investment in new issues of Indian companies under 40% scheme

Non-resident Indians and overseas corporate bodies can make investment in new issues of shares/debentures of any new or existing company (other than a FERA company) engaged in industrial/manufacturing activities or a hospital project or a hotel project of 3, 4 or 5 star category raising capital through a public issue with prospectus up to 40% of the new capital issue of the company with full repatriation rights. They can also invest with full repatriation rights in the capital raised by private limited and public limited companies (engaged as above) other than through the issue of prospectus up to 40% of the issued capital of the company subject to a quantitative ceiling of 4,000,000 Rs.

(c) Investment under 74% scheme

Under the scheme operated by the Government of India, non-resident Indians and overseas corporate bodies can invest in certain priority industries in India with repatriation benefits up to 74% (without any minimum limit). Investment is also allowed in any other industry provided the investor undertakes to export 60% of the output or, in the case of industries reserved for the small sector, 75% of the output. The investment under this scheme is also permitted in case of a hospital project as also a hotel project with 3, 4 or 5 star category. This facility extends only to new investments including expansion and diversification of existing industrial undertakings but not portfolio investment. The scheme is also available for investment in partnership firms engaged in the above types of activities.

(d) Deposits with public limited companies

Non-resident Indians and overseas corporate bodies can place funds with public limited companies (including Government undertakings with limited liability) in India for a period of three years with full repatriation benefits provided the deposits are made in conformity with the prevailing rules and within the limits prescribed for acceptance of deposits by such companies.

III. Payment of compensation to overseas agents

Indian companies are permitted with prior approval of the Reserve Bank to appoint agents abroad for securing direct investment in new issues of shares and debentures by non-resident Indians and overseas corporate bodies and pay compensation up to a reasonable extent on the basis of the quantum of investment actually made with the help of the agents.

IV. Procedural formalities

(a) Portfolio investments

Under the simplified procedure, the Reserve Bank now grants general permission to designated banks in India for purchasing shares/debentures through stock exchanges on behalf of non-resident Indians/overseas corporate bodes, so that the investors are not required to approach the Reserve Bank at the time of each purchase. While granting such permission, the Reserve Bank also grants permission to the designated bank to export the shares/debentures so purchased to the country of residence of the non-resident investor, if so desired by him.

(b) Direct investments

An Indian company proposing to issue shares/debentures to non-resident Indians/overseas corporate bodies is required to make an application to the Reserve Bank for necessary permission. The permission granted by the Bank may also be treated as the Bank's permission to non-resident investors for purchasing shares. The Reserve Bank has also delegated powers to banks to allow refunds of subscription money or excess portion thereof either by remittance to the non-resident applicant or by credit to his non-resident (External) FCNR account, or ordinary non-resident account as the case may be, without reference to the Bank. While granting its final approval for issue of fully paid shares/debentures, the Reserve Bank also grants permission to the investee company to export such fully paid shares/debentures to the country of residence of the non-resident shareholder if so desired by him.

(c) Sale of shares/debentures

Similarly, for permission for sale of shares/debentures on stock exchanges, such non-resident Indians/overseas corporate bodies may make applications to the Reserve Bank by a simple letter giving full particulars of their holdings in quoted shares and debentures. Approvals in such cases are granted valid for one year, providing the non-resident seller an opportunity to sell his holdings and when he desires during the validity of the permission.

(d) Repatriation of sale proceeds

Non-resident Indians/overseas corporate bodies can immediately repatriate the sale proceeds of shares/debentures acquired by them to the extent of the cost of the original investment or actual sale proceeds, whichever is less, without prior clearance from the Indian tax authorities. The balance amount, if any, may be repatriated after the tax liability is settled.

(e) Stipulation of minimum period of holding

The facility of repatriation of sale proceeds of shares/debentures which the purchaser may like to sell subsequently is made available only if the investment is retained by the non-resident at least for a period of one year from the date of registration of the shares/debentures in his name or in the name of the designated bank or the latter's nominees.

V. Non-resident Indian Investment Cell in RBI

The Reserve Bank has set up a special "Non-resident Indian Investment Cell" at its Central Office in Bombay to deal with proposals and enquiries relating to investment in India on repatriation basis by non-resident Indians and overseas corporate bodies. Apart from handling individual proposals expeditiously and systematically, this Cell keeps under continuous review the pace of implementation of various policies and procedural reforms designed to encourage larger inflow of non-resident Indian funds under the various schemes. The Cell also serves as a focal point for contact with non-resident Indians as well as their representatives and bankers in India. All proposals and other references relating to investments by non-resident Indians/overseas corporate bodies on non-repatriation basis, however, continue to be dealt with in the regional offices of the Reserve Bank.

VI. Deposits kept by non-residents in banks in India

As from 1 March 1982, term deposits for one year and above made by non-residents in banks in India carry interest at rates 2% above the rates permissible on domestic deposits of comparable maturities. Such deposit accounts can also be maintained by overseas corporate bodies and trusts.

Bangladesh: Creation of Export Processing Zones

Information supplied by Mr. K.A. Gofran, Editor of *Bangladesh Tax Decisions*.

The Government of Bangladesh recognizes that foreign investment can play a crucial role in promoting economic development. This is in particular true for Bangladesh where capital formation is generally low and technical know-how is limited. For this purpose the Government has decided to establish *Export Processing Zones* (EPZ) in the country

The first EPZ has now been established in the port city of Chittagong and will be known as Chittagong Export Processing Zone (CEPZ). Foreign investors are invited to invest in CEPZ which has so been designed that profit for manufacturers is ensured.

The CEPZ is only 1.5 miles from the principal seaport and 4.5 miles from the international airport. It has started on an area of 658 acres (266 hectares) with provision for further extension to 1,000 acres (405 hectares). The first phase of development including infrastructural facilities and related services is nearing completion.

Three types of investment are distinguished:

1. A 100% foreign owned enterprise including investment by Bangladeshi nationals ordinarily resident abroad

Under this type, total investment cost of the project including cost of construction, raw materials and the entire working capital requirement shall be financed by the entrepreneurs' own foreign exchange resources.

2. Joint venture projects between foreign and Bangladeshi entrepreneurs resident in Bangladesh

Under this type, the cost of capital machinery, spare parts and raw materials shall have to be provided by the foreign partners from funds to be brought from abroad. Local currency cost of the investment including working capital may be contributed by the Bangladeshi partners.

3. Enterprise for 100% owned by Bangladeshi resident in Bangladesh

Under this type, the cost of machinery, spare parts, raw materials and other imported capital goods shall have to be financed under non-repatriable foreign exchange, Wage Earners' Scheme/XPL or such other arrangements as may be approved by Government.

Advantages offered

The following advantages are offered to enterprises investing in EPZ:

- The Bangladesh Foreign Private Investment (Promotion & Protection) Act, 1980 guarantees protection, fair and equitable treatment to foreign private investors.
- Zone enterprises will be allowed a 5 year tax holiday regardless of the size of the investment and number of persons employed.
- After the expiry of the initial 5 years a further rebate of 50% of income tax on export sales will be available.

Imports of capital machinery and spare parts, instruments, apparatus and appliances, including testing and quality control equipment and parts thereof, material and equipment for construction of buildings and factories in an EPZ as well as imported items such as raw and packaging materials destined for re-export are freely allowed into the CEPZ. There is also a complete exemption from payment of excise and export duties on goods produced in the CEPZ.

The Government of Bangladesh guarantees full repatriation of profits and capital.

Employment of foreign technicians will be allowed wherever required. The salary of a foreign technician who is employed in any industry set up in the CEPZ shall be exempted from the payment of income tax for a period of 3 years provided that such salary is not subject to income tax outside Bangladesh.

The availability of an adequate, relatively cheap, trained and easily trainable labour force will permit production at a comparatively low cost. For lack of employment opportunities in the country, a large number of professionally qualified engineers, accountants, management and supervisory personnel, technicians and skilled labourers with an adequate knowledge of English as a working language go to foreign countries for employment. They may be profitably employed by manufacturing industries in the CEPZ.

Foreign and Bangladeshi banks will open branches in the CEPZ and will conduct transactions in local and foreign currencies. Foreign exchange funds of CEPZ enterprises may be kept with the banks in any currency.

CEPZ enterprises can benefit from a large network of Bangladeshi banks with branches abroad and also the foreign banks operating in Bangladesh.

Rules, regulations, import-export documentation and procedures under the EPZ system are being simplified, with minimum formalities. Normally entrepreneurs will have to deal with only one agency for all their requirements.

All charges for power, water, rental fees, etc. will be integrated and brought in a simplified billing system.

A multistoried administrative building is being constructed at the main entrance to the CEPZ. This has been designed to house all offices serving the CEPZ as a whole. The Zone administrative offices, customs, banks, insurance, post and telecommunications, shipping agencies and other services will be housed in this building.

Fully developed industrial plots with adequate infrastructure will be leased out to prospective investors. The initial lease is for 30 years and is renewable. The annual rent amounts to US$ 1.00 per m^2 (US$ 4.047 per acre).

A Foreign Tax under New Proposed Foreign Tax Credit Regulations

by Edward H. Lieberman

On 4 April 1983, the Treasury issued new proposed regulations ("proposed regulations") governing whether and to what extent a foreign tax is eligible for a U.S. tax credit. By its terms, the regulations would be effective for taxable years beginning more than 30 days after publication of the final regulations. However, taxpayers may elect to have the final regulations apply to any open taxable year on a country-by-country basis.

The temporary regulations of 17 November 1980 ("temporary regulations") remain in effect unless and until the new proposed regulations are finalized and become effective. The changes made in the proposed regulations are, in most cases, favorable to taxpayers. The principal changes include:

- creation of "dual taxpayer" status that allows splitting of a tax into creditable and non-creditable components and also provides an elective safe harbor formula by which to make the split;
- a new "multiple charge rule" that allows a credit for an income tax paid even though the amount of the income tax may be used to offset payment to the foreign government of a non-tax amount;
- abandonment of the "comparability" standard – thereby allowing an "in lieu" tax to be creditable even though it exceeds the amount that would have been due had the taxpayer been subject to the generally imposed income tax;
- reversal of the contested tax rule resulting in the disallowance of an accrual of a contested tax (i.e. where the amount is disputed by the taxpayer and the foreign government). Accrual of a contested tax was permitted under the temporary regulations.

How to determine if and to what extent a tax is creditable under the proposed regulations

Step One – Identify the levy

The regulations require a separate analysis of each separate levy. A state or local tax will always be a separate levy from a federal tax because the levies are imposed by different taxing jurisdictions. A more difficult analysis is required in determining whether a single law contains more than one levy. The regulations provide that where the base of a levy is different in kind for different classes of persons subject to it, there will be separate levies even within one foreign law. For example, the U.S. taxes nonresident aliens and foreign corporations not engaged in U.S. trade or business at a 30% rate on certain types of gross income. Thus the base of this levy is considered separate in kind from the rest of the U.S. Internal Revenue Code. However, levies are not separate in kind merely because some provisions for determining the base do not apply to all who are subject to the levy. As an example, the regulations cite the limited application of the "at risk" rules of I.R.C. Section 465 which apply to only certain types of closely held corporations. These rules are held not to result in a separate levy for these closely held corporations even though such corporations may not be allowed the same deductions against the tax base as other corporations.

This paper was prepared by Edward H. Lieberman in the Washington, D.C. office of Cole & Corette. It is based on information available as of 19 April 1983.

[Comment: The line between when a base is different in kind and when it is not is not always clear and the result may often be arbitrary.]

A more easily identifiable type of separate levy results where the tax law of a foreign jurisdiction is actually modified by a contract between the taxpayer and the foreign government.

Step Two – Is the levy a tax?

The regulations define a tax as a compulsory payment (but not a fine or a duty) which is not compensation to the foreign government for any "specific economic benefit". A specific economic benefit would include the right to extract oil or other government-owned minerals. It would not include social security payments or other "general benefits".

It is possible that taxpayers will find themselves in a "dual capacity" – where some of the levy is not compensation for a specific benefit and some is. Under the regulations, splitting of the levy between the tax and non-tax amount is allowed. See *Step Four.*

Step Three – Is the tax like a U.S. income tax?

Only taxes in the U.S. sense are creditable. This means only taxes imposed on realized, net income will qualify. (Withholding taxes and other taxes on gross amounts may be creditable as "In lieu" taxes. See *Step Five.*)

1. *Realization* – If a tax is imposed at the time of events which would give rise to U.S. taxation, such as a sale or exchange, the realization requirement is satisfied. "Early realization", such as a tax on the mere transportation of goods, will also qualify but only in certain specified circumstances and only where there is no subsequent tax imposed on the same amount upon the occurrence of a later event.

2. *Gross receipts* – The tax must be imposed on the basis of actual gross receipts (as opposed to a tax on fictitious receipts or on capital). In the case of transactions between related parties, gross receipts calculated under a formula which is likely to produce an amount not greater than fair market value may qualify under the gross receipts test. The regulations provide an example of a permissible formula in the case of a "headquarter company tax". Under the tax, gross receipts are deemed equal to

110% of the business expenses of the headquarter company (a company that performs management functions for non-resident affiliates).

3. *Net income* – The tax will be imposed on net income where the base of the tax is gross receipts reduced by most significant costs and expenses. (The timing of deductions, however, need not follow U.S.-type rules.)

Step Four – Amount that is creditable

Having determined that the tax qualifies as an income tax in the U.S. sense, there is an issue of how much is creditable. The following could operate to reduce the allowable credit:

1. *Soak up taxes* – To the extent the income tax is selectively imposed on only those taxpayers whose home country allows use of foreign tax credits, the U.S. will disallow this "soak up" amount.

2. *Refunds and credits* – An amount likely to be refunded because it is in excess of a reasonable approximation of the final tax liability may not be credited.

3. *Subsidies* – Where the amount of a tax is directly, or indirectly, returned to the taxpayer, he is not considered to have paid it. For example, where a borrower in country A withholds tax on interest payments to the country B lender, but the borrower may then keep a portion of the withheld funds under country A law, then to that extent the lender will not be viewed as having paid the tax because of the indirect subsidy provided to the lender.

4. *Non-compulsory amounts* – Taxpayers have a duty to contest taxation in excess of what they should have to pay under a reasonable interpretation of foreign law. A failure to exhaust all reasonable remedies in an effort to reduce the tax may result in a loss of credit for the uncontested overpayment under the proposed regulations.

[Comment: *This provision supplements the IRS's powers under I.R.C. Section 482 as adjustments arising under the arm's length pricing rules of Section 482 can also have adverse foreign tax credit side effects. See also Revenue Rulings 76-508 and 80-231.*]

5. *Multiple levies* – Where a taxpayer can offset one levy by the amount of a second levy, the amount paid is considered to be the whole of the second levy and the excess amount of the first levy.

Alternatively, where the liability for a tax is the amount of the greater of two levies, 100% of the amount of the greater levy and none of the lesser levy is considered to have been paid.

6. *Contested taxes* – Under the temporary regulations, contested taxes, in litigation or otherwise, may be credited currently. The proposed regulations would reverse this position and not allow a credit until final liability for tax was established. (See Revenue Rulings 58-55, 70-290 and 77-487.)

7. *Integrated tax systems* – Where the foreign system integrates corporate and shareholder taxation, questions arise as to the amount of the allowable credit and as to whether the corporation or the shareholder is the payor of the tax. The proposed regulations reserve the issue of integrated tax systems until rules of general application can be developed.

[Comment: *The temporary regulations attempted to solve these problems, but the solution appears to have only been applicable in the case of a U.K.-type integrated system.*]

8. *Dual capacity taxpayers* – As earlier noted, taxpayers who pay an amount which is both a tax and a payment for a specific economic benefit will only get credit for the tax portion. Under the (lengthy) dual capacity taxpayer rules the appropriate tax portion can be established by the taxpayer on the basis of facts and circumstances. Alternatively, a safe harbor formula method may be used at the taxpayer's election.

[Comment: *The Treasury has historically resisted the idea of "charge splitting". The principal proponents of charge splitting are companies engaged in extraction of oil or other minerals owned by the foreign state and who pay large "taxes" which the Treasury has always considered to be royalties in whole or in part. A limited form of splitting was contained in the temporary regulations at Section 4.903-1(e)(5); however, this could be used only where the foreign jurisdiction imposed an income tax on significant amounts of income of persons who did not receive a specific economic benefit and, further, only if foreign law required that persons receiving the benefit separately state and compute the income tax portion. Both these requirements have been abandoned in the proposed regulations.*]

Step Five – In lieu taxes

Under the regulations, if the levy is a tax (see Step Two) and the levy is in substitution for, rather than in addition to, the generally imposed income tax, it will be considered a creditable tax "in lieu" of an income tax. The substitution rule will generally be met where the income subject to the levy is not also subject to the generally imposed income tax. A rule that the amount of an in lieu tax must be comparable to and not more than the amount that would be due under the income tax was contained in the temporary regulations, but is abandoned in the proposed regulations.

In lieu taxes are also subject to all the rules contained in *Step Four*.

The MIRAS Touch: Private Sector Involvement in Tax Administration

by H.W.T. Pepper

> Before MIRAS, relief for mortgage interest was given through PAYE (pay-as-you-earn) codes which reflected the allowances enjoyed by the taxpayer, including the allowance for mortgage interest. Under the MIRAS system, the adjustment to the PAYE code for relief from standard rate tax will no longer be made. Instead the taxpayer will pay interest to the lender under deduction of standard rate tax. The Inland Revenue will then compensate the lender for the tax deducted. Relief from higher rate tax will still be given through the PAYE code.

The introduction in April 1983 of the MIRAS system in the United Kingdom will convert tax relief with regard to mortgage interest into subsidised deductions by mortgage institutions. The change will reduce the administrative work in tax offices and prompts consideration of the value of private sector participation in general.

An excellent, now historical, example of private sector co-operation with Government in tax matters was the introduction in the United Kingdom in 1938 of a new tax (National Defence Contribution or NDC) to help finance re-armament.

The tax proposed by the Chancellor of the Exchequer was complex. The private sector realised that the tax was inevitable but put forward a case for a much simpler levy that would produce the same tax yield. Government wisely accepted the proposal and the simpler tax remained in effect until after the end of World War II.

In 1943-44 the United Kingdom introduced PAYE to collect employees' income tax at source through their employers. A similar scheme had long operated in respect of civil servants, and the new style PAYE considerably improved compliance. In practice, all the procedures originally planned were not found necessary and the scheme, which put an extra burden on the employers, was seen to work effectively and was introduced in varying forms in many other countries.

The United Kingdom has taken other initiatives in recent years to simplify tax administration by converting tax reliefs into subsidies, the latter administered largely by the private sector. The abolition of child tax relief has been made possible by universal "welfare" child allowances which also benefit those whose income is below taxable limits.

Life assurance relief has been replaced by a 15% discount on life assurance premiums, financed by Government, which is also beneficial to low-income groups which formerly received no relief because their incomes were below tax limits. The reform, therefore, has produced greater social justice as well as greater administrative economy.

The latest scheme, MIRAS (Mortgage Interest Relief At Source), switches the former tax relief to mortgagors in respect of interest paid on mortgages (up to a mortgage limit of £ 25,000) on their residences into comparable discounts – financed by the Inland Revenue – accorded to them by the mortgage institutions.

The million of mortgagors who are taxable at no more than the standard income tax rate of 30% are not involved in any tax adjustments, but those taxable at higher rates are eligible for extra adjustments as well as the discount allowed by the mortgagee.

The child relief switch did not, of course, affect the private sector because another Government Department took over payment of the additional benefit. In the case of the LAPRD (Life Assurance Premium Relief by Deduction) and the MIRAS schemes, extra work has had to be undertaken by the private sector but there is the consolation that the institutions involved may offer State-financed discounts from life assurance premiums and interest payments, respectively.

From a fiscal aspect, the cost of the subsidy on life assurance premiums is likely to escalate, at least to the extent of the inflation factor (at a somewhat slower rate since premiums on a policy on a life are usually fixed for the duration of the policy). The MIRAS subsidy could, however, actually fall if there were a decline in interest rates, especially if the mortgage ceiling is retained at £ 25,000 although in the longer term the fiscal cost could rise as property prices rise and more people purchase houses, etc.

Other tax sectors where private sector co-operation plays an important role include the following.

Value-added tax (VAT) has been described as a retail sales tax payable by instalments, where each trader handling taxable goods or providing taxable services pays tax on his output and provides tax invoices to those taking up his output (who may be entitled to a rebate on the tax embodied in the price they paid), and at the same time may claim an offset against their own tax bills for the tax invoiced to them by their suppliers – the system is referred to as a "self-checking" device whereby the private sector assists the tax collector in monitoring his taxpayers.

Payment of stamp duties by composition instead of by the individual stamping of documents is mutually helpful to Government and the private sector, though the latter has to maintain the records necessary to compute the duty available for audit by tax officials. The institutions concerned, however, merely send off periodical cheques for the accumulated duty to the tax collector, thus minimising the paperwork necessary on the Government side.

Payroll taxes of one form or another are sometimes levied as an extra charge on an existing tax base, a sort of "piggy-back" exercise. A fairly recent example was the 3½%[1] National Insurance Surcharge levied in the U.K. and collected along with employers' National Insurance contributions. Malaysia and Singapore imposed in 1965 a 2% levy on payroll, initially as a contribution towards Government hospital costs, which was collected along with the existing compulsory levies to fund retirement benefits. In these examples, the extra work, both for Government and the private sector, was minimal because the yield went into general funds and was not accountable to individuals or employers for future benefit, etc.

PROPERTY TAX AND RATES

In countries where property tax is chargeable on the owner of a residence which is mortgaged to a financial institution, a system has been devised by the institutions to collect, along with the monthly payments of mortgage interest and capital, one twelfth of the annual property tax relating to the property.

The property tax is paid over to the tax collector by the institutions in one sum on the due date each year. The arrangement is not imposed by law, and is enthusiastically approved by tax collectors and is in the best interests of the institutions because property tax is the priority debt in the event of forced sale of the property. It is therefore sensible for mortgage institutions to ensure that property tax payments are up-to-date, and this they do by collecting it themselves as part of the initial mortgage bargain.

The system is also convenient for the mortgagor since he is able to pay his tax on an easy payments system. There is, of course, extra work for the private sector but it is self-imposed and the cost is at least partly met by the interest factor on accumulations of property tax collected from the mortgagors but not due for remittance to the tax collector until the statutory date for payment.

In the United Kingdom, property tax takes the form of "rates" payable by the occupier – the person who enjoys the local services financed by "rates". The levy goes back to the days when the vast majority of residences were rented by the occupiers. In the event of non-payment of rates, the collector may be able to levy on the private assets of the occupier, but property tax collectors claim that they never have real problems because the property itself is security for the tax which ranks as a first priority debt.

The position regarding ownership of residential property in the United Kingdom has changed fundamentally over recent decades. Now a clear majority of occupiers *own* their residences. For those owners who have mortgages on their residences it would make sense to introduce the system of linking mortgage payments with monthly rates payments.

In the United Kingdom it is usual for mortgage payments to be made monthly and many rating authorities allow rate payers to pay their dues in 10 instalments, a method which cannot be particularly cheap to administer. If financial institutions collected both sets of payments in monthly instalments, there would obviously be substantial administrative economies, which might even lead to a reduction in rate bills, A 12-month spread (instead of 10) would make things slightly easier for the owner-occupier-rate payer, as well as combining two liabilities into one – there would, therefore, hardly be any complaint from rate payers.

To achieve this reform all that would be needed would be to make rates a priority debt on real estate taking precedence over mortgages, the position which exists, for example, in Canada and the United States. There would clearly have to be a reasonable transitional period, but no elaborate enforcement laws would be necessary – the institutions could be expected to introduce, voluntarily, the system described above in their own (and the mortgagor's) interests.

Another possible fiscal administrative reform which does not so far seem to have been initiated by any country concerns motor vehicles. Insurance of motor vehicles is a vital matter everywhere, and most countries also charge an annual road or vehicle tax, partly to defray the cost of road maintenance, partly to have up to date records of ownership, and road-worthiness, of vehicles.

Every vehicle on the road should be both insured and taxed, and there seems an obvious case for linking the two payments. As the level of insurance and taxes steadily increases, the case for instalment payment grows. In some parts of the world, insurance companies accept quarterly, and even monthly, payments for the substantial annual premiums due. Financial institutions which put up money for buying a car on hire-purchase, or by car loan, also have a keen interest in their pledged vehicle being properly insured and taxed, but such loans are relatively short-term, so that the first stage in reform would be to try to link insurance and tax.

Since the twin pillars of legality for owners of vehicles are that their vehicles should be both insured and taxed for use on the roads and against the risk of the damage they might do to the lives or property of others, it does seem to make sense that single payments might be collected to cover the two liabilities and effect administrative economy.

STAFF SAVINGS

Concrete evidence of administrative economies made possible by using some or all of the above systems is provided by figures from the British Revenue Departments where total staff employed in administering income and capital taxes has been cut from 85,175 on 31 March 1978 to 73,976 on 31 March 1982. Further decreases are expected when MIRAS is installed, and also as a result of the consolidation of some of the smaller collection offices into larger units.

1. Since reduced in stages to 1½% and to 1% by the Finance Act 1983.

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In Memoriam
Professor L. Hart Wright

2 December 1917 – 12 April 1983

With the death of Professor L. Hart Wright the International Bureau of Fiscal Documentation lost a remarkable member of its Advisory Council.

A teacher at Michigan University Law School since 1946, since 1953 as a full professor, Hart Wright was an authority on U.S. and European taxation law. As a teacher he was cherished by his numerous students for whom he always had time. He served as an adviser to the Internal Revenue Service and wrote several large volumes on U.S. federal income tax law, on the procedures within the I.R.S. and on corporation tax and the taxation of international transactions, all in the context of the training programmes within the Internal Revenue Service.

At the Faculty Hart Wright organised seminars on European taxation for which he invited colleagues from various countries. Those who participated in those seminars, as speakers and as students, will not forget the lively manner in which he conducted them and managed to get down to the essential issues. This he also did while in Europe during a sabbatical year when he sat down to "pick his European friends' brains". Though the hardest of examinations, it was not with a sigh of relief that one saw the end of those long sessions but with deep regret because of the enormous intellectual skill and a profound sense of humour and his twinkling eyes with which he discussed fundamental problems.

The many activities and rewards of Hart Wright are listed in an admiring article published in the *University Record* 38:28 of 18 April 1983. One paragraph reads: "For all of us who were his colleagues, Hart's death represents the loss not only of an esteemed colleague, but of a cherished friend. We shall miss his counsel, but even more, his comradeship." This is exactly what we feel at the Bureau. We may add that it was a privilege to have known a man of his calibre and stature.

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M.P. Dominic:

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L'auteur étudie le Budget pour 1983 prononcé par le Ministre des Finances et de la Planification, qui ne contient pas finalement d'importantes modifications.

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Extraits de la présentation du Budget prononcée le 8 mars 1983 par M. Ronnie de Mel, Ministre des Finances et de la Planification. Le Ministre indique qu'il a essayé au cours des dernières années de remodeler le système fiscal afin de créer des stimulants pour la production et les exportations et qu'il souhaite continuer dans la même direction.

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U.S. Expected to Replace DISC with New Foreign Sales Corporation

By Leonard W. Rothschild, Jr. and John R. Beattie

This is the first part of a two-part article. The second part will be published after the DISC replacement legislation is enacted.

After nearly 12 years of providing a substantial but controversial income tax incentive for American exporters, the Domestic International Sales Corporation (DISC) program[1] is expected to be replaced by the U.S. government. The Reagan Administration and the Congress are attempting to restructure the program in a way that addresses long-standing objections of American trading partners while preserving the tax advantages of DISC. They hope to enact a replacement by the end of the year.

HOW DISC WORKS

DISC was enacted in 1971 in the hope of increasing American exports by relaxing and simplifying certain corporate income tax laws,[2] and by providing American exporters with the opportunity to obtain an indefinite, interest-free income tax deferral on at least 25% of their net export income. The Nixon Administration created DISC as a way to compensate for tax incentives that it believed gave some European exporters an advantage over their American competitors, due principally to differences in their respective taxation systems.[3] The United States taxes domestic corporations on their world-wide income, including profits from foreign permanent establishments serving an export market. By contrast, a number of other major exporting countries follow a territorial tax system that exempts from tax export-related income attributable to a foreign permanent establishment. Congress and the Nixon Administration believed that the U.S. tax system posed a competitive barrier for U.S. business, forcing American exporters to incorporate and operate their export operations abroad, with a resulting loss of jobs in the United States.

Furthermore, the value added tax (VAT) systems in many European countries were viewed by the United States as offering an incentive to export local products while impeding competitive imports. This view developed because VAT is typically refunded to exporters, though imposed on imports.

These disparities in the impact of the two systems of taxation, combined with an existing American tax structure that added certain complications and disadvantages of its own, prompted the legislation that brought DISC into existence.[4]

The DISC itself, while technically a separate entity, needed only to exist on paper (that is, with no substance beyond the paper work required to create it, plus a modest initial capital investment of $2,500) in order to qualify its related supplier (normally the owner of the DISC or an affiliate) for the tax deferral.[5] As a domestic corporation, the DISC was not required to conduct any business at all, or even to manifest any degree of physical presence, outside of the United States.[6] Both the deferral provision and the paper-entity provision drew criticism from other nations even before the DISC legislation was enacted,[7] and these features are likely to be revised this year in response to the mounting international objections.

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1. Internal Revenue Code of 1954 (I.R.C.), Secs. 991-997.
2. S. Rep. 92-437, 92d Cong., 1st Sess.
3. Cohen & Hankin, "A Decade of DISC: Genesis and Analysis", 2 *Virginia Tax Review* 7, 25 (1982). (Hereinafter Cohen.) Mr. Cohen, who first proposed the DISC concept in 1969 while serving the Nixon Administration as Assistant Secretary of the Treasury for Tax Policy, argues that the removal of export disincentives in previous American income tax law, not the creation of incentives, was the primary goal of DISC. It was, however, domestic controversy over the cost-effectiveness of DISC as an export incentive that led to reductions in the program in 1975 and 1976. See also Dept. of the Treasury, *DISC, a Handbook for Exporters* 1 (1972).
4. The European tax system was drawn directly into the DISC controversy by way of counter-complaint by the United States, after France, Belgium, and the Netherlands asked a GATT panel to investigate DISC. See text accompanying footnotes 27-28.
5. Cohen, supra note 3, at 25-29.
6. See, e.g. Rev. Rul. 72-166, 1972-1 CB 220.
7. Cohen, supra note 3, at 29.

Under the original legislation, the DISC was deemed to have earned 50% of the net export income of its related supplier. A DISC paid no U.S. taxes on its profits, but the DISC's parent was annually taxed on at least one half of the DISC's profits (whether or not such profits were actually distributed). The DISC deferral arose because the supplier's deductible commissions were normally double the amount of the currently taxed "dividends" from the DISC.

For example, an exporter with $2,000,000 of net export income was allowed to pay a commission of $1,000,000 to a DISC. The DISC was then considered to make a deemed distribution (or an actual dividend payment) of $500,000 back to its owner (normally the related supplier), which was then subject to income tax. The remaining $500,000 was retained by the DISC and not normally subject to taxation unless the DISC became disqualified, or was sold or liquidated. If that money would otherwise have been taxed at the maximum U.S. tax rate of 46%, the tax deferral by using a DISC would be $230,000, or 46% of the DISC's half of the parent's net income. In addition, "related suppliers" of active DISCs, those which did conduct actual export business of their own, were allowed to deduct an additional 10% of the DISC's own export promotion expenses, including advertising, salaries, commissions, and other selling expenses incurred by the DISC in making export sales.[8]

An alternative formula permitted a tax deferral on 4% of the related supplier's gross sales of a particular product or line of products, plus 10% of the DISC's own actual export promotion expenses.[9] Under a provision called the "no-loss rule", a commission computed using this formula could not exceed the amount of profit earned on the sale, because such a commission would leave the related supplier with a loss on the transaction.[10] Both formulas could be used in the same tax year, allowing the DISC to select the more advantageous commission computation on a transaction-by-transaction basis if it desired to do so. In addition, a DISC was free to use an arm's length pricing method, but most DISCs used the two formula methods (50% of net export income, and 4% of gross sales), since they could not justify any significant profit under arm's length rules.

Congress changed its definition of qualified export receipts twice in the mid-1970s. In 1975, it removed natural resource products (including renewable resources as well as oil, gas, and mineral products) from DISC eligibility,[11] and in 1976 it reduced by one half the income deferral allowed on sales of military products.[12] The 1976 legislation also clarified the previous year's restrictions by restoring renewable natural resources, principally timber, to the list of eligible export products.

Congress also made two additional changes in 1976 and 1982 which diminished the attractiveness of using a DISC. The "incremental rule" for large DISCs (those DISCs with income of over $100,000 per year) was introduced in 1976. This rule permitted DISC benefits only to the extent that export sales in the current year exceeded 67% of the average export sales over a moving 4-year base period.[13] The 50% deemed distribution, the portion of income subject to taxation, was increased to 57.5% in 1982.[14] A recent study estimated that these two changes will reduce the average level of tax-deferred DISC income this year to 17% of the related supplier's qualified export income.[15] But even though the average amount of deferred income on a dollar of export sales was decreased from at least 25 cents in the early 1970s to 17 cents today, annual reports prepared by the U.S. Treasury Department have continued to attribute billions of dollars in American exports to the tax incentives provided by DISC.[16]

Those reports have not been without their detractors, however. Critics of DISC, arguing that the increases in American exports in the 1970s were primarily caused by the devaluation of the dollar early in the decade, have complained that the DISC program has brought the United States a proven revenue loss with no proven export benefits.[17]

In order for a DISC to continue to defer its accumulated income from taxation, two tests must be met each year. At least 95% of the DISC's revenue each year must consist of "qualified export receipts",[18] which generally means gross receipts from the sale or lease abroad of property which was manufactured, produced, or grown in the United States. In addition, at least 95% of the DISC's assets at the close of its fiscal year had to be "qualified export assets", that is, export property, certain types of loans from the DISC to its related supplier, and some other specified property.[19]

Failure to satisfy either of the 95% rules could result in immediate disqualification of a DISC, although the law did permit certain remedial steps to be taken in order to avoid a disqualification. For example, if a DISC failed to meet the 95% qualified export receipts test in a year because of sales of ineligible property, it was given the opportunity to distribute an amount equal to the ineligible income to its shareholder, subjecting that amount to current taxation but preserving the tax deferral on the other accumulated income.[20]

Some have criticized DISC for being too complicated.[21]

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8. I.R.C. Sec. 994(a)(2).
9. I.R.C. Sec. 994(a)(1).
10. Federal Income tax Regulation 1.994-1(e).
11. P.L. 94-12, Sec. 603, 89 Stat. 26, 64.
12. P.L. 94-455, Sec. 1101, 90 Stat. 1520, 1655.
13. I.R.C. Sec. 995(e).
14. Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 Sec. 204, 96 Stat. 324, 423.
15. Horst, "An Economic Analysis of the Foreign International Sales Corporation Proposal", 13 *Tax Notes* 1348 (1981).
16. See Dept. of the Treasury, "The Operation and Effect of the Domestic International Sales Corporation", *1980 Annual Report* (1982), which estimates that U.S. exports were $6.2 billion to $9.4 billion higher in 1980 than they would have been without DISC.
17. For a discussion of the various reports and their conclusions, see Cohen, supra note 3, at 30. See also Surrey, "Our Troubled Tax Policy: False Routes and Proper Paths to Change", 17-18 (1980). Mr. Surrey, Mr. Cohen's predecessor as Assistant Secretary of the Treasury for Tax Policy, calls DISC "of hardly any, or perhaps of no, benefit to our exports. . .".
18. I.R.C. Sec. 992(a)(1)(A).
19. I.R.C. Sec. 992(a)(1)(B).
20. I.R.C. Sec. 992(c).
21. One commentator, noting that the General Explanation of the Revenue Act of 1971 devotes 21,000 words to DISC, calls the program "an incredibly complex method of providing only a small subsidy" – Brannon, "The Revenue Act of 1971 – Do Tax Incentives Have A New Life?", 14 *B.C. Indus. & Com. L. Rev.* 891, 901 (1973).

But even with the modifications by Congress in recent years, the program has remained popular with exporters; in fact, the 1,854 additional DISC elections made in 1981 represented the largest such increase in 8 years.[22]

THE GATT CONTROVERSY

The original DISC legislation provided for a "deferral" of income taxes, instead of an exemption, because the General Agreement on Tariffs and Trade (GATT) prohibits "subsidies" of most exports.[23] However, France, Belgium, and the Netherlands were not convinced that there was any practical difference between a DISC tax deferral and an outright subsidy. They lodged immediate protests to GATT, which were soon joined by England and Canada, in an effort to pressure the U.S. into repealing the new program.[24] The U.S., one of the original participants in the drafting of GATT in 1945-47, repeated its rationale for DISC before a special GATT panel that was called to investigate the case.[25] The panel disagreed with the U.S. position, deciding that the effect of DISC was "nullification or impairment" of the export interests of the three nations.[26] The GATT Council, however, never issued a final judgment on the preliminary findings of the panel. In 1981 the U.S. signed a multilateral agreement with France, Belgium, and the Netherlands which terminated the inquiry and appeared to promise that a replacement for DISC would be found.[27]

The defense of DISC before the GATT panel was joined with a U.S. counter-complaint against France, Belgium, and the Netherlands, which alleged that DISC was no more a violation of GATT's no-subsidy provision than were the territorial taxation systems of the European neighbors, and that GATT should not find one system in violation without finding all in violation.

The same GATT panel heard the counter-complaint, and it agreed with the U.S. position by finding that the territorial taxation systems of France, Belgium, and the Netherlands also resulted in "nullification or impairment" of the interests of their competitors in the export market.[28] That preliminary finding was also rendered moot by the multilateral agreement reached by the 4 nations in 1981.

The signing of the 1981 agreement virtually assured the demise of DISC. The Reagan Administration did make a brief attempt to revive the arguments in favor of DISC that had led to its creation, but it soon became clear that DISC had little support abroad and that the controversy was threatening to compromise American positions on other trade issues. Treasury Secretary Donald T. Regan then told GATT on 1 October 1982 that the Administration would find a replacement for DISC.[29]

ADMINISTRATION PROPOSAL

The Administration proposal[30] was released in draft form in March of this year. The final proposal had not been released before Congress took its recess on 4 July, but it was still expected to come in time for Congressional action before the end of the year. The final proposal is not expected to vary substantially in concept from the draft version, although more changes reportedly were being considered with the safe-haven formulas which would be used to calculate the permanent tax savings. The proposed legislation is expected to address, and to satisfy at least partially, the GATT objections to DISC, and still help stimulate U.S. exports. As tentatively proposed, the new "foreign sales corporations" (FSCs), which would replace DISCs, would be revenue-neutral to the U.S. Treasury; that is, the new export incentive would provide the same amount of potential tax savings as DISC.

The FSCs proposed by the Administration would not be U.S. paper entities. They would be required to have a foreign presence that meets several specific criteria. The foreign presence requirement is significant, in that it means that the new corporations would no longer be covered by the GATT provisions on domestic export subsidiaries, but the requirements may cause a new GATT controversy over the threshold of activities needed to achieve a foreign presence. A specified percentage of in-

22. Dept. of the Treasury, supra note 16.
23. GATT, Art. XVI(4): ". . . contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market".
24. For an explanation of the procedures developed by GATT to handle such complaints, see Jackson, "The Jurisprudence of International Trade: The DISC case in GATT", 72 *Am. J. Int'l L.* 747 (1978), and Jackson, "World Trade and the Law of GATT, Sec. 8" (1969).
25. United States Tax Legislation, Report of the Panel, GATT Doc. L/442 (2 November 1976).
26. Id., Para. 69.
27. See "DISCs: U.S.-Europe Tax Pact Finally Adopted by GATT Council", *BNA Daily Tax Report,* 9 December 1981, at G-4. The American position on DISC had undergone a radical change since the panel report was issued in 1976; the Carter Administration had proposed repealing DISC in 1978, and was clearly less inclined than its predecessors to defend it against criticism from U.S. trading partners. See House Comm. on Ways and Means, 95th Cong., 2d Sess., "The President's Tax Program: Prepared Statements of Administration Witnesses", 32 (1978) (statement of W. Michael Blumenthal, Secretary of the Treasury).
In addition, the United States had also agreed in 1979, in the Tokyo Round of the multilateral trade negotiations, to a detailed interpretation of GATT Art. XVI(4), supra note 23, which defines "subsidy" as "the full or partial exemption, remission or deferral specifically related to direct exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises". A footnote to the agreement provides further, however, that "deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected". See Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, GATT Doc. No. MTN/NTM/W/236 (1979), Annex Para. (e); Id., n. 2.
28. Income Tax Practices Maintained by France, Report of the Panel, GATT Doc. L/4423 (2 November 1976); Income Tax Practices Maintained by Belgium, Report of the Panel, GATT Doc. L/4424 (2 November 1976); Income Tax Practices Maintained by the Netherlands, Report of the Panel, GATT Doc. L/4425 (2 November 1976).
29. See 17 *Tax Notes* 708 (29 November 1982). Treasury Secretary Regan said in a letter to the public that "(a)lthough the United States has vigorously defended the DISC, a general consensus has developed among GATT member countries that the DISC is inconsistent with the GATT and that the United States should bring its tax practices into compliance with these rules. The view held by many of the GATT members that the United States is not abiding by GATT rules seriously compromises the ability of the United States to use the GATT to defend its trade interests. Accordingly, the Administration believes that the United States should respect the GATT consensus and attempt to comply with it."
30. For the text of the proposal, approved by the Cabinet Council on Commerce and Trade and presented informally to the GATT Council in March, see 18 *Tax Notes* 978-980 (14 March 1983).

come attributable to the FSC from its related suppliers would be permanently exempt from U.S. tax, as opposed to the tax deferral provided by DISC. This provision is designed to skirt one of GATT's major objections to DISC, because the FSC exemption would closely resemble the exemptions that are built into the territorial taxation system used by the nations that originally objected to DISC.

The use of an outright exemption, instead of a deferral that must be monitored each year as income accumulates, may make FSCs easier to use than DISCs for many U.S. exporters. This is because the annual 95% tests for "qualified export assets" and "qualified export receipts" would be eliminated. The qualified export asset test was particularly troublesome for some large DISCs, because it was often difficult for the owner of the DISC to find sufficient qualified assets in which to invest its accumulated DISC income. The FSC will provide needed relief from the rather stringent rules under DISC. The definition of "qualified export receipts" will not change for the FSCs, but if an FSC makes sales that are not qualified export property (e.g. goods manufactured outside of the U.S.), it will face only a loss of the tax exemption on those sales, not a forfeiture of its special tax status.

The most significant change in the proposed DISC replacement legislation is the foreign presence requirement, which will abolish DISCs both as paper entities and as entirely domestic corporations – for large parent corporations, at least. In order to qualify for an income tax exemption under the Administration proposal, an FSC must meet the following foreign presence requirements:

- Maintain an office outside of the United States. The office may be shared with other entities, and need not be either in the country where the FSC is incorporated or any country in which it is doing business.
- Maintain books and records in its foreign office. These may be summary books and records, and need not be original books of record or entry.
- Have at least one resident director outside of the United States. This director cannot be a resident of the U.S., but need not be a resident of the country where the FSC is incorporated or any country in which it is doing business.
- Hold an exclusive or non-exclusive agency agreement, franchise agreement, or distribution license with respect to the products it sells. This agreement or license applies only to sales of products from related entities. It may be signed at the time of sale and may be terminated at will.
- Participate outside of the United States, either itself or by contract, in solicitation, negotiation, or acceptance of sales. No standard is set for a minimum degree of participation, however.

In addition, the FSC must perform outside of the United States, either itself or by contract, activities that give rise to 50% of the costs attributable to the 5 following functions, or to 85% of the costs of any two of them: processing orders and deliveries, billing customers or receiving payments, advertising or promotion, contracting for payment of commissions, and assumption of credit risks and foreign exchange risks.

The FSC must also perform at least 85% of the following activities outside of the United States: hold board of directors' and shareholders' meetings, maintain a separate bank account and paid-in capital, and disburse dividends, legal fees, directors' and officers' salaries, and accounting fees.

Early versions of the proposal would have required FSCs to incorporate in nations that have tax treaties with the United States. This provision was eliminated in favor of the requirements listed above, which were thought to be easier to administer and enforce.

The Administration proposal for FSC also does not include the "incremental rule", which required a DISC to compare its current-year export sales to export sales over a moving 4-year base period. In its place would be a flat 83-17 safe-haven exemption formula: that is 17% of the related supplier's eligible export income would qualify for U.S. income tax exemption, while the parent would be taxed on the other 83%.

The 17% exemption figure for the new FSCs is expected to be revenue-neutral, because it equals the average amount of export income which DISCs currently defer from U.S. tax. However, larger, slower-expanding DISCs may benefit since the incremental rule, which limited their current DISC benefits, would be repealed. On the other hand, newer DISCs which were not yet adversely affected by the incremental rule will only be able to exempt 17% of their export income from U.S. tax.

An alternative pricing formula, analogous to the 4% method allowed by DISC, would allow the new FSC to earn a tax-exempt amount equal to 1.35% of its gross export sales, up to 34% of the combined taxable income of the FSC and its related supplier from qualified export sales.

Any FSC that uses the 17% exemption formula or the 1.35% of gross income formula would also have to meet an additional requirement relating to foreign business activity. It must, either by itself or by contract, solicit orders from and negotiate contracts with customers, process customer orders, and bill customers and receive payments in connection with its qualified export receipts. An FSC can satisfy this requirement by contracting with its related supplier to perform these activities.

The foreign corporation could use an arm's length pricing method, but, as under the DISC legislation, it is expected that the formula methods will be more widely used.

Any changes in these formulas would also potentially affect the revenue-neutrality of FSC. An increase in the percentages of income to be exempt from tax, which the Administration reportedly was considering while preparing its final proposal, would presumably raise the total revenue cost of FSC.

Since the United States would not tax distributions from the FSC, foreign taxes on its income or dividends would not be entitled to foreign tax credit relief at the shareholder level. Clearly, then, the viability of the FSC depends upon its ability to locate in a tax-favored jurisdiction. After all, U.S. companies are not likely to embrace a U.S. tax-saving arrangement at the cost of an equal offsetting foreign tax cost. Furthermore, it remains to be seen how Congress will view a proposal that some might suggest exports jobs and tax revenues. There may be some hope that a number of countries will enact legislation directed at attracting FSC business, and that such countries would join in information-sharing agreements with the United States.

The Administration proposal offers small businesses two ways to avoid the potential costs related to forming an FSC. One alternative would allow exporters to continue to operate DISCs for sales of up to $10 million. The amount of deferred tax would be subject to an interest charge at the current Treasury Bill rate, but the deemed distribution provision and the "incremental rule" would be eliminated. The savings made possible by the additional tax deferral would offset the additional cost of the interest charge. The other alternative would allow exporters to form FSCs on a joint basis, thus sharing the costs of forming and maintaining an FSC.

The question of whether the continuation of small-business DISCs violates GATT, then, would be GATT's to consider if it so desired. However, the GATT sanction provisions require that actual impairment of a GATT member's economic interest be found before any sanction can be applied.[31] Supporters of the small business exemption believe that small exporters, which reported barely 1% of all DISC income in 1980,[32] will not be found responsible for any impairment at all.

Even if these measures enable the income of the FSCs to qualify under GATT as foreign-source income, one further problem remains: what to do with the tax-deferred corporate income accumulated so far under DISC – the full 12 year's worth, for some exporters. The amount of deferred taxes may be as high as $6.5 billion, assuming a 46% tax rate on the outstanding tax-deferred DISC income of $14.5 billion.[33] While the original provision for a deferral implied that taxes previously deferred would fall due eventually, both the Congress and the Administration have given serious consideration to forgiving the debt. One element of that consideration is the belief that GATT would not impose a sanction for past violations alone, if the pending legislation replaces DISCs with GATT-legal corporations. Whether this is true is not known by either Congressional or Administration supporters of DISC replacement legislation. However, the sentiment appears to be that GATT should be satisfied to obtain the changes in the Administration proposal.[34]

The primary concern of the Administration and the Congress is not the possibility of a direct GATT sanction against the United States, but rather the continued integrity of GATT as a medium for solving international trade disputes. When Treasury Secretary Regan announced last year that he would seek to replace DISC, he stressed the importance of good relations with the United States' trading partners without conceding any actual GATT-illegality on the part of DISC.[35]

The Administration would replace DISC primarily to preserve the United States' own interests in GATT as a dispute-solving mechanism, because it believes the U.S. has more to lose than it has to gain so long as DISC remains an issue. The U.S. has several cases of its own pending before GATT right now, and the Administration believes those cases might receive more favorable treatment if DISC were not available as evidence that the U.S. is not living up to its own GATT obligations.

Three members of Congress have introduced DISC revisions or replacement legislation of their own in recent months. These bills were written before it was known whether the Administration would offer its own proposal. When the White House said it would join in drafting legislation for a DISC replacement, work on the 3 pending bills was stopped in anticipation of the Administration version, which is expected to be adopted by Congress without major revision.

CONCLUSION

While the DISC program has been the object of significant domestic criticism for most of its lifetime, it seems unlikely that any serious attempts to revise or replace it would have been made this year if it were not for GATT. To that end, whatever legislation eventually is adopted will seek to address international concerns rather than domestic ones – and to do as little harm as possible to the interests of American exporters.

The White House has put considerable effort into the drafting of this legislation. While Congress is expected to make at least minor changes, the Administration proposal is expected to be adopted essentially as drafted. One possible area of Congressional revision is the amount of the FSC tax exemptions, which may attract considerable controversy in a year of domestic debate over the U.S. budget in general.

While the imposition of a foreign presence requirement would settle GATT complaints over alleged tax subsidies for domestic corporations in the future, any legislation forgiving the DISCs' accumulated tax debt might expose the United States to precisely the type of GATT controversy it is seeking to avoid.

31. GATT, Art. XXIII. The panel reports in these cases did not cite any evidence of actual harm, however. They concluded that the taxation systems of the respective countries caused "prima facie" cases of nullification or impairment. GATT Doc. L/4422, supra note 25.
32. Dept. of the Treasury, supra note 16.
33. Id.
34. Cohen, supra note 3, at 55-57.
35. *Tax Notes*, supra note 29.

Protocol to Canada–United States Tax Treaty

On 14 June 1983 Canda and the United States signed a Protocol amending the 1980 Canada–U.S. tax treaty, which has not yet been ratified. A "Release" of the U.S. Department of Finance states:

The Honourable Marc Lalonde, Minister of Finance, and the Ambassador of the United States to Canada, His Excellency Paul Robinson, today signed a Protocol amending the 1980 Convention between Canada and the United States of America with respect to taxes on income and on capital.

Since the signing of the 1980 Convention, a number of meetings have been held by specialized groups, both in Canada and in the United States, allowing a number of deficiencies and ambiguities to be identified. Also, since that time, the United States government has legislated new provisions dealing with the tax treatment of dispositions of direct or indirect investments in United States real property by non-residents.

The Protocol consists of fifteen Articles.

Article I – Redefines the term "international traffic" contained in Article III(1)(h) (General Definitions) of the Convention.

Article II – Expands the provision of Article V(4) (Permanent Establishment) of the Convention to include "an installation".

Article III – Determines that Article VI (Income from Real Property) of the Convention applies to all income from natural resources including resource royalties in respect thereof.

Article IV – Eliminates a conflict which exists between Article VIII (Transportation) and Article XII (Royalties) of the Convention.

Article V – Deals with the scope of the exemption for copyright royalties provided under Article XII (Royalties) of the Convention and clarifies the source rules therein.

Article VI – Under the existing (1942) Convention, gains are generally taxable only by the country in which the taxpayer resides. Under Article XIII (Gains) of the Convention, this exemption is removed and each country will in future have the right to fully tax gains on domestic real property realized by a resident of the other country. However, for properties held on September 26, 1980, only those gains accruing after the end of the year of the entry into force of the Convention will be taxed. This is provided for under Article XIII(9) as amended by the Protocol and is referred to as the "safe-start" rule, Article XIII(3) of the Convention limits the taxing rights of the country where the property is situated when real property gains are realized indirectly through shares of a company or an interest in a trust or partnership that holds real property. A number of criteria were established in the 1980 Convention specifying the circumstances in which such indirect gains may be taxed by the source country. The Protocol removes the criteria and changes the meaning of real property. This expands, for each country, the right to tax certain gains. However, for gains on property owned on September 26, 1980, which are now exempt under the 1942 Convention, the exemption will continue to be preserved under the safe-start rule to the extent of the gain accrued before the end of the year in which the Convention enters into force. The amendments to Article XIII(9) extend the safe-start rule to cases where exempted property is transferred on certain tax-free re-organizations.

Article VII – Extends the application of the rules provided under Article XVI(3) (Artistes and Athletes) of the Convention to the income of a team and introduces a new paragraph limiting to 15% the withholding tax on signing bonuses.

Article VIII – Extends the application of the rules provided under Article XVII(2) (Withholding of Taxes in Respect of Independent Personal Services) of the Convention to employees.

Article IX – Corrects a technical problem in Article XVIII (Pensions and Annuities) of the Convention by replacing the exemption provided therein with a deduction in calculating taxable income.

Article X – Ensures that the exemption provided under Article XXI(2) (Exempt Organizations) of the Convention also applies to pension plans that invest in foreign securities for the benefit of other pension plans.

Article XI – Removes the last sentence of Article XXIV(1) (Elimination of Double Taxation) of the Convention, adds a credit mechanism in Article XXIV(2) to deal with the departure tax and also adds a new paragraph concerning the source rules for the purposes of the United States foreign tax credit.

Article XII – Clarifies the application of Article XXV(6) (Non-Discrimination) of the Convention as regards inter-corporate dividends.

Article XIII – Introduces a number of changes to Article XXIX (Miscellaneous Rules) of the Convention. Article XXIX(2) is an anti-avoidance provision; Article XXIX(3) is the savings clause; Article XXIX(4) reflects the fact that the Social Security Agreement has been signed; Article XXIX(5) deals with Canadian registered retirement savings plans; and Article XXIX(6) relates to what is generally referred to as an "anti-treaty shopping" provision.

Article XIV – Deals with the application of the United States foreign tax credit rules.

Article XV – Sets out the mechanism for the entry into force of the Protocol and of the application of its provisions.

The signature of this Protocol constitutes an important step in the process of eventual ratification of the Convention by both countries.

Tax Ratio and Tax Effort Analysis: A Critical Evaluation

By M.M. Ansari

I. INTRODUCTION

A considerable amount of time and effort has been devoted to examining the dimension of tax problems pertaining to less developed countries (LDCs) during the last decade. These include attempts to trace major factors which account for variations in tax levels of different countries. While the interest of individual contributors lies mainly in academic pursuits (see Martin and Lewis 1956, Hinrichs 1966, Thorn 1967, Shin 1969), a vast literature emanating from international organisations, particularly the International Monetary Fund (IMF), has tried to estimate the taxable capacity and assess the efforts made in raising tax revenues of the member countries (see Lotz and Morrs 1967, Chelliah 1971, Bahl 1972, Tait et al. 1979). The findings and implications of the IMF studies on taxation might have far-reaching effects on economic planners and politicians as well, leading them to misplaced emphasis on either a higher or lower tax level without conducting any examination of the prevailing economic conditions in their respective countries. Moreover, since many of the planners in LDCs may not, in the true sense, be fully aware of the technical intricacy from which results are derived, the conclusions drawn may not necessarily be appropriate to assist in policy formulations. In view of such repercussions, this paper seeks to examine the rational ground of such studies in a way that lends a realistic perspective to the appraisal of their utility. The examination might help the users who rely upon the information contained in these studies to assess the results of these studies in the proper context.

The basic objectives of this paper are twofold. One is to present a synthesis of the motivations behind the growth of literature on the subject and to outline the methodology employed. The other, and more important, objective is to comment on the studies completed to date. The plan is as follows. Sections II and III briefly describe the methodology and its limitations, and state the rationale for inter-country comparisons of taxation. This provides informative background material for evaluating the validity of the criticism set forth in this paper. Section IV discusses the choice of the model upon which the IMF studies are based. The arguments as offered by the proponents on the variables incorporated in the model are discussed to determine if they are tenable. Section V contains a critical analysis of the tax ratios and the tax effort indices, including, where appropriate, comments concerning some misleading conlusions which seem to have been drawn by the authors of the IMF technical papers on tax problems. In addition, an attempt is made to examine whether the objectives outlined in Section III have been realized. Section VI, the last section, contains a discussion of a wide range of problems encountered in fiscal analysis and suggests some remedial courses that might ameliorate the usefulness of the fiscal studies.

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II. METHODOLOGY

(i) The regression analysis approach

All of the IMF studies pertaining to tax problems in LDCs have employed the accepted technique of regression analysis. The objective of this approach is to establish the extent of the relationship between a given country's tax ratio (i.e. overall tax revenue divided by Gross National Product (GNP)) and what are considered to be the significant factors which affect the taxable capacity of a country. The factors generally chosen are per capita income, the degree of "openness" (i.e. amount of foreign trade) of the economy, and some measure of the relative shares of the various economic sectors in order to reflect the composition of the economy. After the regression coefficients are derived through proper specification of the model, hypothetical tax ratios are then estimated for each country. These hypothetical tax ratios measure the average capacity of the country. Finally, the actual ratios are compared with the predicted or estimated ratios to derive tax effort indices.[1]

There is an alternative method called the representative tax system approach. In effect, this approach sets up a model tax system or structure of rates which is applied to the several tax bases in each country (this method generally has been applied to different states within a country). The yield of the model tax structure is compared with the actual yield of the existing tax system in each country, thereby providing an index of tax effort. The results obtained from this approach, however, do not differ significantly from those obtained through regression analysis (see Bahl 1972).

(ii) The limitations of this approach

Regression analysis depends upon the availability of comparable data and upon the correct specification of the model on a priori theoretical grounds. The use of different classifications of national accounts and the lack of uniformity in the definitions of the term taxes and in other variables related to the model do not provide reliable data that are required for inter-country comparisons. Moreover, social and institutional factors are hard to conceptualise, let alone to measure for policy analysis.

If the estimating equation is specified incorrectly, misleading estimates of the coefficients are likely to be made; collinearity among regressors causes diffulties in estimating the coefficients. If the regressors in the multiple regression equation are collinear, individual coefficients will have little significance. The major weakness of such statistical analysis approach, then, is that any misstatement of a hypothesis may cause an incorrect interpretation to be accepted or a correct one to be rejected summarily (cf. Morss 1969 and Shourie 1972).

The problem involved in employing the regression approach in International Comparisons of Taxation (ICT) studies is similar to the one indicated above. The results obtained from such analysis may be suspect, mainly because so many important factors related to socio-economic conditions and the political climate are not incorporated in the regression equation, i.e. the model of taxable capacity. The omission of some relevant variables obviously would produce distortions in the estimates for the included variables. The major drawback in such analysis, therefore, is the inability to quantify some important variables, particularly those related to behavioural changes. Furthermore, if the purpose is to assess the tax performance of a group of countries, it is essential to include all the independent factors affecting taxable capacity in order to formulate the model on an a priori justification, the lack of which invalidates the methodology described above. Some authors have recognised the limitations of the approach yet they seem to have attached a lesser significance to the non-economic factors. To quote Bahl (1972: 88): "The regression approach does not allow a desirable examination of the kinds of explicit relationships between particular taxes and particular economic structure variables that would seem useful for the purposes of making inter-country comparisons of taxable capacity and tax effort." Properly speaking, it is not the "economic structure variables" alone which matter most in regard to the taxable capacity of a country and its taxation policy. In fact, tax policy is politically very sensitive, and to evaluate tax policy one must understand the government's decision-making process with respect to altering the socio-economic structure, which ultimately influences the tax bases and tax rates through overall economic policy. Such an idea is essential to supplement one's knowledge of traditional patterns of taxation in the country. Since the variables related to the non-economic aspects are not incorporated in the regression equation, they constitute a major weakness of the approach.

III. OBJECTIVES: WHY INTER-COUNTRY TAX COMPARISONS

It is believed that inter-country and inter-temporal comparisons of patterns of taxation are helpful in analysing the inter-relationships between different aspects of the economy, such as the stage of development, the level of taxation and other related factors. A detailed systematic ICT aims to shed light on individual characteristics of the tax structures of a variety of countries. Moreover, it helps evaluate the tax policy of one country against some average or standard performance of a group of countries with somewhat similar socio-economic characteristics.

A brief survey of the literature reveals that ICT studies have been carried out for the following main reasons:[2]

(i) To accelerate the rate of economic growth LDCs are required to create and raise adequate domestic resources. In order to speed up their development plan, "Underdeveloped countries need to raise at least 17% of the gross national product in taxes and other government revenues, taking central and local authorities together" which "is within the reach of most countries" (Martin and Lewis 1956: 128-129).

The first rationale put forward in support of ICT is, therefore, to determine "whether a given country could

1. In other words, the index of tax effort is the quotient of the actual tax ratio to the estimated tax ratio.
2. This section is based partly on Bird's 1976 paper.

not, if it wanted to, raise more taxes without seriously burdening the economy" (Chelliah 1971: 259). After making allowance for major variations, it is argued that an inter-country comparison illuminates whether or not a country could mobilize domestic resources through taxes to the extent of some pre-determined average. Tax yield below the average level establishes a prima facie case either for the existence of potential taxable capacity or for a thorough examination of the tax system and structure (Chelliah 1971: 299). A poor tax performance, in terms of raising revenue is presumably a pointer to either deficiencies in the tax structure policy or an inadequate effort on the part of the government to collect taxes.

(ii) The effectiveness of government development efforts in the less advanced countries have recently been cast in doubt. It has been found that foreign capital inflows have resulted in increased public and private consumption rather than increased savings and investments, and have contributed less to growth than was anticipated.

Some donor countries and international lending organisations have suspected that their clients, i.e. aid recipient countries, are using foreign aid as a substitute for domestic savings. To check this trend, ICT studies also try to detect and identify such countries which might have supplemented their aid requirement from domestic tax efforts had they not abstained from adequate taxation for reasons other than economic efficiency. In short, such studies provide some criterion to appraise the performance of aid recipient countries in raising additional resources internally. This presumably forms one basis for being eligible for foreign aid. Needless to add, such a criterion probably is indispensable in view of the fact that foreign aid may be fruitful when it is a complement to domestic effort rather than a substitute for it, and particularly when there are limited funds available for disbursement.

(iii)Furthermore, like bankers, donor countries assess a prospective borrower's ability to pay back a loan without undue internal or external financial strains.

(iv)It is argued that depending upon the structural characteristics of the economy, the revealed preference for income distribution, the desired rate of growth of income, the demand for public services and other related aspects, a tax structure or a certain level of tax revenue must be consistent with the desired national goals. In order to design a suitable tax policy and to set future growth targets, it is therefore important for a tax economist to have full information and knowledge about the economic experience of other economies with similar characteristics. For this reason, "government decision makers often resort to the use of comparisons with other countries to gauge the performance of their own fisc. The basic use of tax effort comparisons is related to this kind of internal fiscal analysis" (Bahl 1971: 573).

Not only tax planners but also politicians seem to have been making a case for higher or lower tax levels on the basis of such comparisons. The head of a planning department has said that "judging from the tax efforts of more progressively developing countries, the low tax effort in our country can only suggest that there is a wider room for further taxation" (Sicat 1972: 3, cited in Bird 1976: 245).

(v) Nonetheless, academic pursuit of knowledge seems to be a factor influencing the growth of the literature. Availability of data, given the quality and better understanding of the techniques, has hopefully helped develop new methods of comparing fiscal performance in a variety of countries as the subject matter is of crucial importance. Therefore, many individual contributions on the subject are of academic interest.

IV. THE MODEL: A CRITIQUE

An econometric formulation of a model requires that the choice of explanatory variables should be based strictly on a priori reasoning. It has been argued, mainly in the IMF studies, that three major factors exert a strong influence over the tax ratio and are, therefore, relevant indicators of taxable capacity. These variables are:

(1) the stage of development as measured by per capita income;
(2) some sectoral composition of income as measured by the share of industry and mining and agriculture in the gross domestic product (GDP); and
(3) the size of overseas trade, i.e. the extent of "openness" of the economy.

These variables are supposed to explain variations in the tax ratios and, subsequently, are used as proxy variables for determining the taxable capacity when appraising the tax effort performance of a country vis-à-vis the performance of other countries. We shall first briefly describe the main arguments for the choice of the above variables and later we shall discuss them critically.[3]

It is argued that there is a strong positive correlation between the stage of economic development and per capita income. A higher per capita income is an indicator of a higher level of development, reflecting a higher degree of monetisation, urbanisation, industrialisation and level of literacy. This eventually is an indicator of ability to pay taxes and ease in collection. Furthermore, "per capita income has considerable normative significance in considering taxable capacity" (Chelliah et al. 1975: 191).

It has been argued, further, that the share of agricultural income in GDP can be an alternative measure of the stage of development. "A higher level of activity in the agricultural sector will be associated with a large subsistance sector, less commercialisation and industrialisation and a lower per capita income" (Bahl 1971: 522). This indicates a low taxable surplus owing to the:

- relatively low incomes of farm workers;
- low profit margin, more particularly in the case of small farmers; and
- lack of administrative ease.

Furthermore, due to the fear of political resistance, "many developing countries have found it politically difficult to tax the agricultural sector" (Chelliah et al. 1975:

3. It may be mentioned that the experts, notably Prest (1972, 1979), Bird (1976) and Peacock (1979), have questioned the rational grounds of such studies. We do not, however, intend to pursue or reiterate what has already been covered except when it unavoidably intrudes.

191). Therefore, "a large agricultural share is found to be a strong predictor of low tax ratio" (Bahl 1971: 590).

Mineral production also generates a larger taxable surplus than other sectors of the economy. It is agrued that, "because of heavy fixed investment associated with extractive industries, operations tend to be confined to a few large firms and as long as world demand conditions ensure high profitability there exists a combination of taxable surplus and administrative ease" (Chelliah et al. 1975: 295). Further, since mining companies are largely foreign-owned it would be politically feasible to levy high taxes because "effective resistance to higher tax levels will be less" (Bahl 1971: 590).

A higher level of foreign trade activity reflects a greater degree of monetisation and industrialisation and, hence, administrative ease in the collection of taxes. Moreover, "favourable world market conditions for certain primary exports create a relatively large taxable surplus in export earnings and, therefore, a greater taxable capacity" (Bahl 1971: 585). Since the share of exports in GNP is more closely related to the tax ratio than the share of imports in GNP or the proportion of exports plus imports in GNP, it is a good index of the size of foreign trade.

It has been argued, further, that the volume of foreign trade is significant, probably due to the high proportion of minerals and oil in total exports and, therefore, in total income also. Thus the mining export ratio is needed to "make allowance directly for the export in countries where mining is not so important" (Chelliah et al. 1975: 297). In brief, all the three major variables are significant in explaining differences in the tax ratios and a combination of these is a good proxy measure of taxable capacity.

However, the first problem arises from the large variance in per capita income. Inter-country per capita income differences within the sample of countries below $ 1,000, as in Tait et al. (1979), for instance, are very large, hiding a number of characteristic features related to taxable capacity. These features may be the relative size of various sectors; the degree of monetisation and urbanisation; the structure and quality of administration and the level of literacy which varies greatly among countries.

The second problem stems from conversion of per capita income in terms of national currencies into a common unit, normally U.S. dollars at official exchange rates. Exchange rates may be overvalued, particularly for countries with high inflation rates, thus giving a misleading picture of taxable capacity, for there is always a lag in adjustment of official exchange rates.[4]

A further problem arises from a specification error of the model.[5] Statistical estimation of parameters requires that all the variables incorporated in the model be independent so as not to obtain biased estimates. An examination of the components of the three explanatory variables reveals that there is a collinear relationship between the export ratio and the share of mining and agricultural sectors in the total income. In other words, contributions towards income from both mining and agriculture are components of total exports. This problem, for instance, has been dealt with in one of the five sets of estimating equations yet it is not fully solved. After making allowances for the shares of export income and minerals in total exports, the resulting equation – according to the statistical criteria which perform most satisfactorily – is as follows:

$$1972\text{-}76(47)\ T/Y = \underset{(6.15)}{9.9949} + \underset{(-0.34)}{0.0008}(Y_p - X_p) + \underset{(5.41)}{0.4048}\,Ny + \underset{(3.12)}{0.1938}\,X'_y$$

$R^2 = .413 \quad F\ (3,43) = 11.80$

$$1972\text{-}76(63)\ T/Y = \underset{(4.82)}{7.1134} + \underset{(0.94)}{0.0024}(Y_p - X_p) + \underset{(9.31)}{0.5700}\,Ny + \underset{(4.17)}{0.2218}\,X'_y$$

$R^2 = .581 \quad F\ (3,59) = 29.69$

where T/Y = tax ratio, $(Y_p - X_p)$ = per capita non-export income in U.S. dollars, X'_y = export ratio excluding minal exports, N_y = share of mining in GDP (including petroleum), 1972-76(47) refers to regression on the Chelliah et al. (1975) sample of 47 countries employing 1972-76 data and 1972-76(63) refers to the same regression set run on a new sample of 63 developing countries with per capita GNPs of less than $ 1,000.
Source: Tait et al. (1979: 28-29).

"Statistical merit" and "goodness of the fit" of the equation reported above have been cast in much doubt and have become debatable. To quote Bird, "this equation is used because the purpose of this exercise is *not* to 'explain' variations in the tax ratios among different countries but rather to measure 'taxable capacity'. The successful measurement of the taxable capacity used in these studies depends critically on the *a priori* justification of the explanatory variables as affecting *only* taxable capacity and not at all either demands for higher public expenditures or willingness to tax". He further adds, "per capita income is presumably included because it is a proxy for a potentially higher tax base, or a larger 'taxable surplus'. But in fact income is surely as much a 'demand' as it is a 'supply' factor: the identification problem seems insuperable in this respect (Bird 1976: 253). The choice of the model, therefore, does not comply strictly with the econometric norms.

Many of the developing countries facing severe problems of financing developmental programmes do levy taxes up to a feasible desired level, as and when tax bases are

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4. The extent of distortion, however, depends on the degree of progressivity of tax structure. The error in taxable capacity may be illustrated by the following example which is due to Bahl (1971: 588). Taxable capacity (T/Y) may be defined as a function of per capita income (Y_p) in terms of the country's existing exchange rate.

$T/Y = a+bY_p \ldots\ldots\ldots (1)$
It may be rewritten in the form
$T/Y + a+bY'_p/R \ldots\ldots\ldots (2)$

Where R is the official exchange rate and Y'_p is per capita income measured in the local currency unit.

Taking a partial derivative with respect to R, we have

$$\frac{\partial\,(T/Y)}{\partial\,R} = -\frac{bY'_p}{R^2}$$

This shows that the tax ratio will differ by $-\,bY_p/R^2$ for every currency unit per U.S. dollar difference in the exchange rate (given a per capita income expressed in local currency units).

5. Bahl, however, has recognised the problem arising from collinearity (Bahl 1971: 572).

available and identified. The IMF studies show that tax levels are rising in almost every country over time. It is, moreover, common kwowledge that most of the governments of these countries collect a large proportion of revenues through indirect taxes, the incidence of which generally falls on poor consumers who could be given relief on equity grounds. Moreover, some governments resort to the use of various tactical devices and impose taxes in disguise wherever possible. It seems, therefore, unrealistic to argue that powerful governments should not wish to tax even where taxable capacity exists. The point of this discussion is simply to demonstrate that the low level of taxation in LDCs is the result of socio-economic and institutional constraints rather than, as often stressed, unwillingness of the governments.

Many authors have argued that LDCs with large agricultural sectors find it difficult to assess and tax small farmers because of a lack of administrative ability, probably implying thereby a higher cost of collection for a small amount of tax revenue. This problem also seems to be slightly exaggerated. There is no denying the fact that since a majority of people have a low per capita income, per head consumers' surplus for taxation purposes would be accordingly low. But a small per head amount of tax, collected from a large number of people, would certainly constitute a handsome amount. The cost of collection of taxes should not be high because salaries of tax collectors are also substantially low. Many developing countries do seek to tax like this.[6]

The mining sector is important, as proponents have argued, from the point of view of taxation chiefly for two reasons: firstly, high profitability in the mining business; and, secondly, the lack of effective political resistance because of heavy foreign investment. This is also a naive observation. Many giant multinationals are in fact notoriously difficult to tax properly. Despite the generous tax treatment of foreign firms as compared to that accorded to domestic firms, they often circumvent monetary and fiscal policies of the host country because, "in addition to tax concessions, some foreign firms have both opportunities and motives for substantial avoidance of host country taxation" (Morton and Tullock 1977: 218-219). This task is facilitated because of their economic and political influence at the national and international levels and they easily pressurise the host governments in several ways, thus escaping higher taxation. Furthermore, long term business agreements with the host government may not always legally allow imposition of additional taxes, despite increased profitability. It is, therefore, difficult to estimate the true potential of the mining sector for taxation. One cannot, however, deduce that more taxes could be levied if there were no such problems as indicated above.[7]

Lastly, we take up the case of overseas trade. In view of the fact that total exports are inversely related to the size of population (Chenery and Syrquin 1975: 40-41), it is important to restrain from making generalisations about the significance of export ratio as important variable for measuring taxable capacity, disregarding the rate of growth in the population. The argument that, with the growth of the economy, the role of foreign trade taxes declines because of the availability of income-linked tax bases may not necessarily be true for all countries. This is because a rapid growth in population may increase the domestic demand pressure for traditional export items due to a rise in internal absorption capacity.[8] Moreover, collections from transaction taxes like sales taxes and excise duties may or may not rise depending on the size of the subsistance sector. The different characteristics of the population factor, therefore, have to be reckoned with while taking the export ratio as an import factor in determining taxable capacity, particularly in the context of developing countries where population growth is almost unchecked.[9]

This is not to deny that the variables incorporated in the model are insignificant but to assure that the inter-relationships within the included variables and also between the included and excluded variables are, indeed, complex. In dealing with the problems involved in assessing the fiscal performance of a country, the technique of regression analysis is inefficient and the data are lacking. The concepts of taxable capacity and tax effort are, therefore, not easily susceptible of measurement.

V. TAX RATIOS AND TAX EFFORT INDICES: A COMMENT

International comparisons of taxation are made mainly on the basis of the simple tax ratio, i.e. overall ratio of tax to aggregate national income. Traditionally this ratio has been used to measure the tax burden in developed countries (see Needleman 1961, Tanzi 1970, Bird 1964). This concept is generally applied to indicate the level of taxation which an underdeveloped country should have, given the conventionally acceptable level.[10]

The other basis employed for assessing performance in collection of tax revenue is the index of tax effort, as defined earlier (the ratio of actual tax collection to estimated tax revenue), which gives a better idea, proponents claim, of the intensity of use of taxable capacity of a country when compared with an average performance of a group of countries. The objective of such an analysis is to know whether or not a country has made adequate attempts to mobilise domestic resources through taxation policy. Let us examine both the bases of comparison separately in the light of the discussion in the preceding section and see the extent to which these are sensibly attuned to the objectives.

(i) Tax ratios

Evidence from earlier studies shows that the average tax ratio has increased in LDCs from 13.1% to 13.8% during the period 1953-55 to 1966-68. The trend continued and

6. Measurement of efficiency in collection of taxes in terms of total yield, however, is a matter of judgement since reliable data for such analysis are hardly available.
7. Because much depends on the proportion of the total minerals exported and/or internally consumed and the extent of tax shifted, in the short run.
8. However, tax revenue from consumer goods may increase if the tax structure is progressive and prices are rising continuously because of demand push inflation.
9. An analysis of the effects of the population factor on the tax ratio and tax effort may be seen in Ansari (1982: 1040).
10. Martin and Lewis (1956: 229) suggested in their study that LDCs should mobilise up to 20% of their gross national product in tax revenue.

rose to 16.1% in 1972-76 as compared to 15.1% in 1969-71 (Chelliah 1971, Tait et al. 1979). The average level of taxation in LDCs is, however, still much below that in developed countries. For OECD countries, the tax ratio has risen from 22.86% in 1966 to 26.26% in 1975 (excluding social security contributions) (OECD 1977). The structure of taxes, i.e. relative significance of individual taxes, seems to have been changing over a period of time. This is true for both developed and developing countries (Messere 1976).

Since the tax ratio has been used as one of the measures of the size of the public sector, it is contended that "the tax ratio gives an idea of (a) the division of responsibilities between the public and the private sectors; and (b) the degree of control that the government can potentially exercise over the disposition of purchasing power in the economy" (Chelliah 1971: 250). This is another naive observation made on the basis of tax ratio. Since the dimensions of the problem related to the measurement of both the numerator (taxes) and denominator (GNP) are complicated by incompatibility of data, such conclusions are debatable in nature and are subject to qualification for the following reasons. Firstly, the percentage contribution towards GNP from each of the two sectors to the total value added is not reflected in the simple tax ratio[11] because transfer payments, etc. are not accounted for in GNP. Like other sources of income, transfer payments are equally important in influencing spending power in the aggregate. Secondly, so far as the government's potential purchasing power is concerned, it is hard to estimate the extent of intervention a government can exercise through its non-fiscal policies, such as regulatory and discretionary measures, which greatly affect the purchasing power of both the public and private sectors. In view of this, the contention that comparisons of the tax ratios of different countries indicate the relative share of government revenue collected in taxes, or, in other words, that purchasing power is essentially transferred from the private to the public sector, gives a misleading picture. Furthermore, a high or low tax level does not give any idea as to whether it is affected by changes in the composition of taxes and rates or because of improvements in compliance and administrative efficiency. The varying degree of tax evasion and tax avoidance in different countries will greatly distort the tax ratio. Therefore, no definite conclusion can be drawn from inter-country comparisons. However, one reason given for low tax ratio, it is interesting to note, is as follows: "the main impediment to a higher tax ratio is the unwillingness of the government to raise taxes" (Bahl 1971: 572). This again may not necessarily be true, as many developing countries have shown a better tax performance. Similarly, the stage of development and/or other characteristics of the economy are not reflected in the tax ratio. Further, some of the developed countries in the OECD have a much lower level of taxation than most of the LDCs (OECD 1975: 36). This seems to point out that the tax ratio is not even a composite indicator of "tax burden" or "tax sacrifice" as has been the case in some of the earlier studies mentioned above. The fact is that even "countries with similar measurable economic characteristics differ considerably in proportion of GNP raised in taxes" (Chelliah 1971: 310), due primarily to the differences in tax structure policy and the rate of inflation in different countries. It may, therefore, be noted that the traditional tax ratio analysis does not greatly assist the assessment of tax burdens or provide a guide as to the proportion of GNP a country can raise through taxes.

(ii) Tax effort indices

The notions of taxable capacity and tax effort are closely linked. It may be noted, in passing, that due to inter-country differences in the components of both taxes and GNP, the varying definitions of the term "taxes" and the use of different classifications of national accounts, it is hardly possible to obtain a comparable tax ratio.[12] Moreover, a number of intangible factors, e.g. objectives of government, nature and quality of political leadership, efficiency in tax administration, social and institutional factors and statutory tax provisions, are not taken into account in the tax ratio. The notion of taxable capacity, as defined earlier, thus becomes elusive. It is probably assumed that the model of taxable capacity, as discussed in the preceding section, is properly specified and anticipated revenue is measured. The ratio of actual tax collection to predicted tax revenue gives the index of tax effort which, in effect, indicates how much of the existing capacity is used at a point of time or how far capacity is in use through time. A better or poor tax performance of a country is judged from an acceptable standard performance of a group of countries.

A number of factors may be said to affect the index of tax effort. Most important among them are (Tait et al. 1979: 137):
- changes in the prices of taxable commodities;
- extent of the monetised sector combined with ease in collection of taxes;
- discretionary and/or automatic changes in the tax structure.

It is difficult to isolate the factor(s) which most influence(s) the index. This constitutes the major weakness of tax effort analysis from the point of view of policy implications, and any attempt to derive a definite conclusion from such an index may be extremely hazardous. For instance, it has been suggested that "the countries with a high and rising tax index might prudently seek ways of curbing the growth of the public sector" (Tait et al. 1979: 137). This conclusion is probably based on the assumption that growth of the public sector is necessarily bad, even in the context of the LDCs. In many developing countries the private sector has neither sufficient initiative – due mainly to paucity of finance and lack of technical skill – nor many avenues to develop private entrepreneurship. In LDCs the growth of the public sector is therefore desirable and conducive to economic development. Since the tax effort indices indicate nothing about the size and efficiency of the public sector, it therefore becomes difficult to conceive the rational basis of such a conclusion. Such a view, however, seems to reflect the ideological predilections of the authors rather than an

11. Chelliah, however, has recognised this problem.
12. Although international organisations, namely the IMF and the OECD, have attempted to standardise definitions of various terms, the problem of classifying certain items is not yet fully solved (see OECD 1977 for comparisons of the OECD, UN and IMF systems of classification).

appraisal of the economic and institutional settings of the countries in which these suggestions are to be put into practice.

In the same study the matter has been further confused. The authors contend that, "ranking countries according to tax effort takes into account international differences in taxable capacity, and compared with simple tax ratio, more accurately measures the sacrifice undertaken in order to raise tax revenue. It provides information about the capacity of countries to respond to fiscal problems by raising the level of taxation" (Tait et al. 1979: 125). In the same paper it is also noted that "the most outstanding result of these tests of different equations and groupings, at a point in time and through time, was the apparent vulnerability of the absolute ITC indices [tax ratios and tax effort] to change in the sample" (Tait et al. 1979: 144-145). These conclusions contradict the findings, obviously suggesting that the index of tax effort is not a satisfactory measure of the tax performance of a country.

From the above discussion it can also be deduced that tax performance measured by the index of tax effort is neither a satisfactory nor a sufficient basis for allocating aid. The observed behaviour of governments and their actions lends support to this point of view. It has been discovered that increased tax revenue is not necessarily conducive to economic development as, in some LDCs, a large portion of high tax revenue has been squandered on non-productive forms of public consumption. To quote Please: "the disappointing behaviour of the public savings in less developed countries in spite of impressive records of tax performance is due to the growth of public expenditure" (Please: 1975: 40). This observation weakens the argument that a high tax ratio is an indicator of a country's ability to raise resources through taxation for development purposes. An obvious conclusion which emerges from Please's study is that more taxes may imply more spending, which may not necessarily be productive. It seems, therefore, that taxes are not all that important in a country's ability to mobilise resources from domestic efforts. In fact, the major weakness of these studies is that they do not scrutinise all the factors at work. Some of the factors related to socio-economic aspects may be of local and regional importance but insignificant in international comparisons and can hence be ignored. Any conclusion, therefore, drawn from a simple tax ratio or from an index of tax effort which does not reflect sensitivity to some important variables is likely to do more harm than good in bringing about reforms in tax structure. It is a well known fact that politicians manipulate economic instruments in appraising domestic policy so as to serve their own vested interests, and often in disregard to long term economic effects. A misleading comparison may form the basis for politicising the issue for lower or higher taxation and such an approach can misdirect the country's fiscal policy.

It is no secret whether eligibility for foreign aid is determined by a country's tax performance or by its network of political and economic relations in the international arena. The truth is that, in practice, economic factors may not be significantly related to the chances of getting foreign aid. In the context of government lending, Gunnar Myrdal notes that, "international finance spills over into the indeterminate ocean of power politics, where crackpots and demagogues swim with great pleasure" (Myrdal 1966: 112). These observations clearly tarnish the rational grounds and the objectives of ICT studies, as outlined in Section III.

VI. SOME CONCLUDING REMARKS

It is not unusual to find that studies on international comparisons of taxation and expenditure suffer from the omission of some important intangible factors. They nevertheless contribute towards an understanding of fiscal conditions and their relationships with other economic variables. There are reasons for believing that in fiscal analysis aimed at estimating potential financing capabilities it is neither appropriate nor feasible to incorporate all the relevant variables in the model, given the statistical regression approach and its shortcomings. However, it is important to take into account all the measurable characteristics of variables that could be said on a priori grounds to affect fiscal capacity.

Even if this problem is somehow resolved, two further questions arise if the purpose is to obtain a composite indicator of fiscal capacity. Firstly, what measurable characteristics should be taken into account? Secondly, what significance should be attached or how much weight should be given to each of the characteristics? While it all depends upon the precise objectives of the investigator and, to a greater extent, on particular fiscal aspects which he wants to elucidate, an improper choice and undue importance given to a particular variable may lead to serious distortions in the result. Moreover, if the cost of achieving a set of objectives and the implications of alternative weights attached to variables are ignored, the consequence may be hazardous and destabilising. These problematical issues recommend caution in comparative fiscal exercises.

Traditionally, most researchers seem to have concentrated either on the tax side or the expenditure side of the fiscal account. Such concentration is not always useful because of the interdependence between variables within the fiscal structure as a whole. The problems associated with the studies pertaining to taxable capacity lend some support to the proposition that a better picture of the potential financing capability of a country from its domestic resources could emerge if the composition of government revenues as well as expenditures were analysed together, in order that its effective uses could be studied in proper perspective. To quote an authority "it is hardly permissible to measure tax effort without regard for the expenditure side of the budget" (Musgrave 1969: 160). In fiscal analysis, moreover, some institutional factors are also important. It has, therefore, been noted that "even if one agrees that improving tax yields is a necessary condition for achieving the commonly accepted aims of developing countries, this does not absolve the investigator from having to justify the concentration of attention on the tax side of the account and from quantifying the results which are supposed to emanate from specific institutional reforms" (Andic and Peacook 1974: 96). In such studies, therefore, a detailed examination of all the relevant factors at work, including the administrative and socio-political structure, is desirable.

But this is no easy matter. Firstly, because in any case the conceptual and statistical problems cannot be eliminated fully. Secondly, there is no ingenious technique which will overcome all the difficulties mentioned above. To minimise these problems, however, the analysis could better be carried out at the national, or even below at the State, levels simultaneously for a sample of countries employing a conventionally acceptable method. It would then enable the researcher to study the impact of specific fiscal policies on budgetary trends which have, consequently, an important bearing on the process of economic growth through the distribution of income, savings and investments of both the public and private sectors. In other words, such an approach may allow for a thorough examination of the relative efficiency of various fiscal tools vis-à-vis the economic objectives of the country, given the socio-political structure. It might also be possible to evaluate the effectiveness of fiscal instruments in a country vis-à-vis standard performance of other countries. It would then give an idea as to what kind of policy instruments are comparatively best suited to a particular set of aims, in a specific economic and political environment.

As noted above, there is no technique which can incorporate all the relevant variables in the model. This further aggravates the problem. In the case of some significant factors, there are formidable difficulties in quantifying the extent of their effects on fiscal policies. For instance, experts generally agree that, inter alia, geo-cultural factors and the governments' willingness to tax domestic resources, either for political reasons or on the grounds of social welfare considerations, are significantly related to the tax systems and structures. Likewise, national goals and the supply of and demand for public services are related to the size and composition of public expenditure. The strength of these relationships varies from one country to another, as a result of which their effects on the various sectors of the economy and other growth-related changes vary between the countries. Moreover, while the impact of geo-cultural phenomena or socio-economic settings may be peculiarly important for a certain country, and may differ among countries, the role of political processes in fiscal decision-making may have some common dimensions among many countries. One may also expect a sort of uniformity in the evolutionary process of various countries under the given political structure, although the duration may differ. In view of this, it is imperative to construct suitable indices of the relevant factors so that after making due allowance for major inter-country variations, international comparisons of potential fiscal capacity or its effective uses can be made.

Furthermore, depending upon the public choice as reflected in the revealed preference for a set of fiscal policies, the governments of some LDCs may prefer to postpone levying new taxes or increasing the rates, in the short run, even though there may be some scope for further taxation. Instead, they may resort to internal heavy borrowing for financing public service schemes or even developmental programmes. Although a number of problems are encountered in assessing the potential for internal borrowing, some idea of such capacity is useful to make suitable adjustments for comparisons.

Nonetheless, as we have mentioned above, inter-country fiscal analyses are fraught with many difficulties arising from significant differences in economic, social, political and organisational structures. The impact of a given change in the independent variables is likely to vary substantially between different LDCs. Therefore, the result obtained by employing a regression analysis approach may not be reliable either for generalisation of theory or for practical policy purposes. However, it does not imply that such statistical exercises are not useful. Such attempts continue to provide a basis for encouraging technical discussions on the assessment of fiscal policies and measurement of their overall impact on economic development. Further, they improve our understanding of the process of the changing features of developments in a cross-section of countries. The potential value of these studies rests in tracing out indicators of fiscal determinants and in developing a comparative measure of fiscal capacity and patterns of change which have considerable implications for economic planners concerned with designing and innovating appropriate taxation measures.

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In September/October issue:

The next issue of the *Bulletin* will be a double issue (September/October) which will be largely dedicated to the 37th Congress of the International Fiscal Association in Venice (Italy). A great number of distinguished Italian authors and authors of other nationalities contributed to this issue. The main articles include:

Tax policy in Italy
– by *Francesco Forte,* Minister of Finance

General principles for the determination of business income in Italy
– by *Antonio Lovisolo*

Italy: Tax and civil law aspects concerning the annual balance sheet
– by *Flavio Dezzani*

Tax treatment in Italy of international transactions between affiliated companies
– by *Guglielmo Maisto*

Foreign tax credit in the Italian system
– by *Gian Carlo Croxatto*

Taxation of capital gains realized by non-residents on the sale of interests in Italian corporations
– by *Siegfried Mayr*

The taxation of interest and dividends in Italy
– by *Augusto Fantozzi*

Payment of taxes and the ability to pay in Italy
– by *Gianni Marongiu*

Le sécret bancaire en Italie à l'égard du fisc après la réforme de 1982
(Banking secrecy with respect to the tax authorities after the 1982 reform)
– by *Furio Bosello*

Republic of San Marino: tax and exchange control
– by *Adriano di Pietro*

Evasion, évitation et fraude fiscale (Avoidance, evasion and tax fraud)
– by *E. González*

Tax evasion – The present state of non-compliance
– by *Nathan Boidman*

SRI LANKA:
Budget 1983

by Dr. M.P. Dominic

There were hardly any new concrete tax proposals in this year's Budget. The major tax changes, namely, increases in the business turnover tax rates and import duties, were already made by Gazette notification prior to the Budget date.

This year's Budget speech first reviewed the performance of the Sri Lankan economy after its liberalization in 1977. The second part mainly consisted of proposals to finance an overall deficit of 29,352 million Rs.

Performance for 1977-82

Prior to 1977, private initiative and enterprise were severely restricted and constrained. Exchange, import and private sector investment controls nearly crippled the economy. In 1977, the new Government dismantled the exchange and import controls and adopted a more realistic exchange rate policy. Private sector investment was encouraged through tax and other incentives.

During the 1978-82 period, the economy grew at an average rate of over 6% per year in real terms which "is nearly double the rate of growth during the period 1970-1977".

Investment as a percentage of GDP, at current market prices, increased from 14% in 1977 to 29.5% in 1982. In the organised sector, the employment opportunities created during the period 1978-82 are estimated at 1.12 million. The Minister has stated that more employment opportunities must be created in the unorganised sector. Industrial production increased at an average 4.9% per annum for the period 1978-81 and 8% in 1982. In the Free Trade Zone a total of 170 projects were approved, but until now only 52 are in operation and they employ 22,813 persons and produce exports valued at 1,655 million Rs. per annum. Capital invested amounts to 1,306 million Rs. Investment has mainly been in the garment sector. In the Free Trade Zone, foreign investors may invest without any local participation requirement and without exchange restrictions. The tax incentives offered include tax holidays and reduced taxation during the post-tax holiday period.

Outside the Zone, foreign investment is under the purview of the Foreign Investment Advisory Committee (FIAC) which approved 561 projects during the period 1978-82 of which 271 are in operation. Capital invested is 3,901 million Rs. including foreign capital equivalent to 1,709 million Rs.

During this period, a total of 15 foreign banks opened branches in Colombo. In addition, two banks have representative offices. In 1979, an offshore banking scheme was introduced with a view of promoting Sri Lanka into an international financial centre. Commercial banks were encouraged to maintain Foreign Currency Banking Units (FCBUS) through which they could accept deposits and grant credit in designated foreign currencies. It is not clear from the Budget whether the scheme has been successful.

Despite these achievements, the economy still faces a number of difficulties. The revenue of the Government has declined from 27.4% of GDP in 1978 to 17.2% of GDP in 1982. On the other hand, the capital expenditure has consistently grown during this period resulting, despite the decline in current expenditure in terms of percentage of GDP, in considerable overall budget deficit. In addition, the balance of payments position is precarious. The value of imports is more than twice the value of exports resulting in an estimated trade deficit of 848 million SDR in 1982. Domestic savings have averaged only 13% of GDP during 1978-1981. On the other hand, gross domestic investment during the same period has averaged 28% of GDP. If no corrective action is taken it is estimated that the debt service ratio could be as high as 27% of export earnings by 1986.

Tax proposals

The overall budget deficit is expected to be 29,352 million Rs. In fact, the current total revenue is inadequate to meet even recurrent expenditure. The main aim of the Budget proposals, including the tax proposals, was to find ways to finance this trade deficit.

The tax proposals mainly consisted of increases in the business turnover tax rates and import duties. These increases were, in fact, imposed by Gazette notification prior to the Budget date and the Budget speech merely explained the reason for the increases.

Business turnover tax (BTT)

At present, credit is given for BTT paid at the time of import against BTT payable at sale. With effect from 19 February 1983 no such credit will be given to the importer. This credit placed the importer of finished goods at an advantageous position over domestic manufacturers.

The basic rate was increased from 2 to 4%. Other rates were increased by 2.5 and 5 percentage points. The BTT rate on tourist hotels was reduced from 20 to 15%. For cement, fertiliser, petroleum products, sugar and liquor, BTT will be charged only at the point of import or at the point of manufacture; but, the rates have been adjusted so as not to lose any revenue.

Import duties

Some import duties of 5 to 10% have been increased by 2.5 percentage points. All other import duty rates, other than rates of 100% and above, were increased by 10 percentage points. Goods which have hitherto been imported duty-free have been subjected to a 5% duty.

The Minister explained the rationale for these increases as follows:

> . . . We are conscious of the fact that these measures place certain burdens on the people of this country. We have tried to mitigate them by taxing mass consumed articles at a relatively low rate and the non-essential and luxury items at higher rates . . . . We have to increase our revenue and cut

down our expenditure. Given the choice between indiscriminate price increases through inflationary financing of the budget and selective price changes through judicious reforms in the tax structure, I have chosen the latter.

Export promotion and development

The Minister has promised to grant certain tax concessions to the export sector. This will be part of the export development strategy drawn up by the Export Development Board. The 5-year tax holiday on profits other than tea, rubber and coconut products will continue even after 31 March 1983, the cut-off date for other tax holidays.

Energy conservation

The necessary legislation is being prepared for the creation of an Energy Conservation Fund. All public contributions to this Fund will be exempt from tax.

Investment relief

The 100% investment relief for investments in large hotel projects and large scale agricultural and urban development projects will not be available after 31 March 1983 except for investments in projects approved prior to that date. The 33⅓% investment relief will continue.

Construction of a house

The 5-year tax deduction will be extended to 15 years for individuals constructing houses with their own capital.

Tea – Ad valorem sales tax

(1) The taxable point will be adjusted from 22 to 26 Rs. per kilogramme.
(2) The Tea Board Cess will be increased from 90 cents per kilogramme.
(3) Subsidies for replanting will be increased.

Rubber

(1) The sliding scale of export duty will be adjusted so as to reduce the duty by 1 R. per kilogramme.
(2) Subsidies will be increased.

Other changes

The Minister has commissioned a study of the tax system with a view of recommending further changes. It is reported that exemption of annual taxable income of 24,000 Rs. and the possibility of replacing income tax with turnover tax are under study.

SRI LANKA:

Budget 1983

Extracts from the Budget Speech pronounced by Mr. Ronnie de Mel, Minister of Finance and Planning, on 8 March 1983.

A detailed discussion of the Sri Lanka tax system is published in the International Bureau of Fiscal Documentation's publication: *Taxes and Investment in Asia and the Pacific.*

. . .

Free Trade Zone

The Greater Colombo Economic Commission has made impressive progress when compared with the performance of Free Trade Zones elsewhere in the Asian region.

A total of 170 projects have been approved of which 52 are already in operation. These projects employ 22,813 persons and produce exports valued at Rs. 1,655 million per annum. Investment in the projects totals Rs. 1,306 million. Initial investment was largely concentrated in the garments industry. However, there has recently been a shift in emphasis and a more diversified pattern of industries is now emerging in the Free Trade Zone. It is particularly heartening that we have been able to get started in the micro-electronics field.

Foreign Investment Advisory Committee

Foreign investment outside the Free Trade Zone comes under the purview of the Foreign Investment Advisory Committee (FIAC). Here, again, much has been achieved. A total of 561 projects have been approved during the period 1978-82, of which 271 have commenced activity. Direct employment has been provided for 21,233 persons.

Total investment in FIAC projects amounts to Rs. 3,901 million, of which the foreign component is equivalent to Rs. 1,709 million. Foreign investment has been attracted from a number of countries. The work of the Foreign Investment Advisory Committee has contributed significantly to economic growth and to the generation of employment and foreign exchange earnings during the past five years.

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Another significant feature of the fiscal operations was the increase in the net receipts on Advance Accounts. The revised estimates for net recurrent expenditure is, therefore, about Rs. 490 million less than the original estimate.

Mr. Speaker, the decrease in anticipated revenue is due to several reasons. The decline in import duty and turnover tax on imports may be attributed to two factors. The volume of imports has been lower than what was projected. This is due to the withdrawal of lump sum depreciation, the restriction of bank credit and the availability of large stocks in the country. In addition, the tax base has been reduced due to the appreciation of the Sri Lanka rupee vis-à-vis some major trading currencies like the pound sterling, Deutsche Mark, Japanese yen and the French franc. Export duty collections have also been lower due largely to the decline in rubber prices.

A decline in domestic excise receipts has also contributed significantly to the reduction in revenue. There has been a decline in the demand for coconut arrack, due to a shift in demand towards lower dutied molasses arrack.

Despite an increase of revenue from other sources amounting to Rs. 358 million, the net position is a substantial decline of Rs. 1,602 million in the total estimated revenue. The details are as follows:

(a) *Increases*

	(Rs. Mn.)	
Moter vehicle licence tax	100	
Repayment of loans & advances	73	
Receipts from state enterprises	60	
Income tax	49	
Capital transfers	34	
Current transfers	19	
Social security	12	
Sales and charges	11	+ 358

(b) *Decreases*

BTT		−843	
Import duties		−400	
Import duty on tea	60		
Export duty on rubber	255		
Export duty on coconut	7	−322	
Excise on liquor		−220	
Rent, interest and dividends		− 93	
Excise on beedies		− 70	
Ad valorem tea tax		− 10	
Other taxes		− 2	−1960
			−1602

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FINANCIAL YEAR - 1983

Mr. Speaker, the Draft Estimates presented to this Honourable House provide for a gross expenditure of Rs. 49,655 million. This compares with an estimated expenditure in 1982 of Rs. 38,800 million approximately.

Recurrent expenditure will increase from Rs. 20,600 million in 1982 to Rs. 25,662 million in 1983. Capital expenditure is estimated to increase from Rs. 18,240 million in 1982 to Rs. 23,993 million in 1983. Almost the entirety of this capital expenditure is on present ongoing projects. As I have already indicated the Government Budget has simply no room to accommodate new projects in 1983 and 1984.

Mr. Speaker, the estimated revenue for 1983 at tax rates prevailing at the time of preparation of the Draft Estimates is Rs. 20,803 million. This compares with an estimated revenue of Rs. 17,717 million in 1982 indicating growth in revenue of 17.4%.

In summary, the Budget picture for 1983 without taking recent increases in taxes and the depreciation of the rupee into account is as follows:

		(Rs. million)
(i)	Recurrent expenditure	−25,662
(ii)	Advance account net payments	− 500
		−26,162
(iii)	Revenue	+20,803
	Current account deficit	− 5,369
(iv)	Capital expenditure	−23,993
	Overall budget deficit	−29,352

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PROPOSALS

Mr. Speaker, the financing of this overall deficit of Rs. 29,352 million is indeed a most formidable task. Our total revenue is inadequate to meet even our recurrent expenditure. In other words, our own revenue is not contributing anything towards the financing of our vast and unprecedented capital expenditures. On the contrary, we are utilising some of the resources which should be available for financing that capital expenditure to meet the current account gap. This surely, Mr. Speaker, is an untenable position, coming, as it does, on top of large current account deficits in past years. These deficits together with burgeoning capital expenditure have been well in excess of the capital resources which we could mobilise from domestic and foreign concessionary sources. Consequently, there has been heavy recourse to the domestic banking system as well as foreign commercial borrowing. This simply cannot continue. It will lead us to disaster.

Mr. Speaker, our Government is determined to put the country on the correct course for the next six years. We cannot drift. We must begin now. On the 18th of February the Government implemented a series of changes in import duty and business turnover tax with a view to increasing our revenue. I need not describe these in great detail because the relevant Gazette Notifications will be placed before this House.

Business turnover tax

Mr. Speaker, let me, however, explain the broad features of the changes. The basic rate of BTT has been increased from 2% to 4% and other rates have been increased by 2.5 and 5 percentage points. At the same time the BTT rate on tourist hotels has been reduced from 20% to 15% while gem and jewellery exports have been exempted from BTT. The recession in these industries has been a severe threat to the widespread employment which they provide. The excise duty on tobacco has been increased from Rs. 282 to Rs. 295 per kilogramme and the BTT has been increased from 35% to 40%. Cigarettes have been exempted from BTT, except at the point of import and manufacture. The impact of these changes is to increase the price of a cigarette by 5 cents.

Mr. Speaker, apart from cigarettes, I have also treated cement, fertiliser, petroleum products, sugar and liquor as items on which BTT will be charged only at the point of manufacture. I have done this for administrative convenience. There will be no loss of revenue because the rates have been adjusted so as to recoup the losses at other trading levels.

Import duties

Mr. Speaker, in regard to import duties, all imports which were hitherto admitted duty free have been subjected to a 5% duty. Some import duties of 5% have been increased to 7½%, while some duties of 10% have been increased to 12½%. All other import duty rates have been increased by 10 percentage points. Rates of 100% and above remain unchanged.

Mr. Speaker, under the Business Turnover Tax Act No. 69 of 1981, an importer is treated as a manufacturer for BTT purposes and the BTT paid at time of import is given credit against the tax payable at sale. This has resulted in placing domestic manufacture at a disadvantage vis-à-vis the importer of finished goods. I propose to remove this disadvantage by denying such tax-credit to the importer of finished products. This requires an amendment to the law. I propose to implement the amended law when passed with effect from midnight of 18th/19th February 1983, the date on which the proposal was announced.

Mr. Speaker, the exchange rates of the rupee vis-à-vis foreign currencies have changed since the Draft Estimates were prepared. These changes have their impact on revenue, expenditure and foreign financing of the Budget. In the revised Estimates which I will present towards the end of my Speech, I will incorporate the impact of these changes.

Mr. Speaker, along with these changes in BTT and import duties, I also revised the tax structure on beedi-wrapper leaves and beedies. The import duty on beedi-wrapper leaves was fixed at 5% with the normal 4% BTT at the point of import. The BTT on beedies was raised from 15% to 20%. With these changes it became possible to liberalise the import of beedi-wrapper leaves which was hitherto a monopoly of the Tobacco Industries Corporation. This liberalisation will be a boon to many thousands of small scale beedi manufacturers and their workers in rural areas who will now have ready access to their main raw material. This should also help them to improve the quality of their beedi, which is the poor man's smoke. We also expect the large scale smuggling in beedi-wrapper leaves to decline as a result of the liberalisation of imports.

Mr. Speaker, we are conscious of the fact that these measures place certain burdens on the people of this country. We have tried to mitigate them by taxing mass consumed articles at a relatively low rate and the non-essential and luxury items at higher rates, ranging up to 100% and beyond. Mr. Speaker, we simply have no choice in this matter. We have to increase our revenue and cut down our expenditure. If we indulge in continued bouts of excessive inflationary financing, the impact on the people would be even more severe in the long run. Thereby, our entire political and social fabric will be threatened.

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Tax incentives and proposals

Tax holidays

Mr. Speaker, you will recall that in my last Budget Speech, I proposed that tax holidays should not be a permanent feature of our tax system and that 31st March 1983 will be the cut-off date for approval. Since then, the Inland Revenue (Amendment) Act 1982 has given effect to this proposal. This means that all tax holidays, other than those approved up to 31st March 1983, will stand abolished. However, Mr. Speaker, in my previous remarks on export promotion I said that I wish to single out the export sector for special treatment. I, therefore, propose to continue even after 31st March 1983, the five-year tax holiday on profits from exports, other than tea, rubber and coconut products. I will introduce amending legislation for the purpose.

The loss in revenue as a result will be negligible in 1983.

Investment relief

Mr. Speaker, the Inland Revenue Act now provides for normal investment relief up to one-third of an investor's assessable income. It also provides for 100% investment relief in large hotel projects and large scale agricultural and urban development projects. While 100% investment relief was necessary in order to get some large projects going, I do not think that it should become a permanent feature of our tax system. I propose, therefore, to have a cut-off date for approval of 100% investment relief and to fix this date as 31st March 1983, except in those cases which have already been approved. Investment relief up to one-third of assessable income will continue to be given.

Relief on construction of a house

Mr. Speaker, at present when an individual constructs a house using his own capital, he can claim tax relief only for 5 years, whereas an individual obtaining a loan can claim tax relief as long as the loan is in force. I propose to correct this anomaly by extending the 5-year period to 15 years for an individual constructing a house using his own capital.

Plantation sector

Mr. Speaker, I have always been emphasizing the paramount need to revive the plantation sector. The performance of this sector is vital if we are to achieve the needed improvement in our balance of payments in the short and medium term. In order to assist this sector, I have progressively reduced export duties over the last 5 years and at the same time provided increased incentives such as higher rates of subsidies for replanting, new planting and development of the tea, rubber and coconut industries.

Tea

The tea industry in Sri Lanka has witnessed difficult times over the past decade. A serious drop in production and a decline in the real prices of tea have combined to weaken the contribution of the tea industry to the economy of the country. The Government is alive to the need to rehabilitate and develop the industry and has taken several measures towards this end. During recent months there has been a marked improvement in tea prices. This is most welcome. Producer prices at the Colombo Auctions have risen from an average price level of Rs. 18 per kilogramme in 1982 to well over Rs. 30 in January/February of this year. At the last tea auction the average price for all teas rose to Rs. 35 per kilogramme. An all-time record.

It is necessary that Sri Lanka should take full advantage of the prevailing high prices by making every effort to increase productivity and improve the quality of our tea. In order to provide further incentives for this purpose, I propose to grant the following tax relief to tea producers:

The taxable point for the ad valorem sales tax will be adjusted from Rs. 22 to Rs. 26 per kilogramme. This would benefit all tea producers whose tea fetches a price above Rs. 22 per kilogramme.

Mr. Speaker, I have included in my Draft Estimates only Rs. 150 million on account of the ad valorem tax on tea. With improved prices, I estimate the revenue will now go up to Rs. 480 million. The concession which I have now proposed will result in a loss of Rs. 150 million, leaving a net revenue from this source of Rs. 330 million.

Mr. Speaker, replanting is one of the most important development programmes for the tea industry. The national target of replanting 2% of the acreage annually has not been achieved during recent years. In order to provide additional incentives for replanting, the subsidies paid under the Replanting Scheme will be increased as follows:

Private Sector Estates and Small Holdings –

(a) the subsidies for low grown areas will be increased from Rs. 10,000 to Rs. 12,000 per acre; and
(b) the subsidy for high and mid-grown areas will be increased from Rs. 12,000 to Rs. 14,000 per acre.

State Sector –

(a) the subsidy for low grown areas will be increased from Rs. 8,000 to Rs. 10,000 per acre; and
(b) the subsidy for high and mid-grown areas will be increased from Rs. 10,000 to Rs. 12,000 per acre.

The Tea Board Cess meets the expenditure on subsidies for tea replanting, factory development, infilling, as well as research projects and promotional activities overseas. I propose to increase the rate of the Tea Board Cess from 90 cents per kilogramme to R. 1 per kilogramme in order to generate additional funds for the development of the industry.

Rubber

Mr. Speaker, the recession in the industrial countries continues to hurt our rubber producers. The fall in the international price of rubber can be directly linked to the slump in the demand for automobiles in the West. In the United States for instance, car production in 1982 hit its lowest level in recent history. In order to arrest the decline in prices due to excess supply in the market, the International Natural Rubber Organisation built up an international buffer stock of 400,000 metric tons. Sri Lanka has also contributed Rs. 120 million to the International Natural Rubber Organisation last year towards the cost of this operation. During this year, a further sum of Rs. 40 million will be contributed.

Mr. Speaker, the export duty on rubber was reduced in 1981 in the context of low prices to assist the producers. The sliding scale of export duty which was introduced also automatically reduces the duty, when the world prices decline. The depreciation of the Sri Lanka rupee has granted some measure of relief, but it is not adequate to maintain producer margins in real terms, and ensure the viability of the rubber plantations. In order to grant more relief, I propose to adjust the sliding scale of duty so as to reduce the tax by R. 1 per kilogramme. The loss in revenue as a result will be around Rs. 110 million for the rest of the year.

In order to provide further assistance to the rubber industry, I propose to enhance the subsidies for replanting and new planting in rubber. The increase per acre will be as follows:

	Private Sector Estates and Small Holdings	*State Sector*
(1) Replanting	From Rs. 7,500 to Rs. 9,000	Rs. 5,000 to Rs. 6,500
(2) New planting	From Rs. 6,750 to Rs. 8,250	Rs. 2,750 to Rs. 5,000

The proposed increases can be accommodated within the existing Cess Funds.

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The tax system

Mr. Speaker, over the years I have tried to refashion the tax system in order to provide incentives for production and export. This year I have continued with the same objectives in mind. Production and exports will be priority number one in our economic strategy of the next six years. I have also commissioned a study with a view to recommending further changes. I expect to be able to present concrete proposals in this regard at the time of amending the Inland Revenue Act if they are ready by then. If not, I shall present such amendments later.

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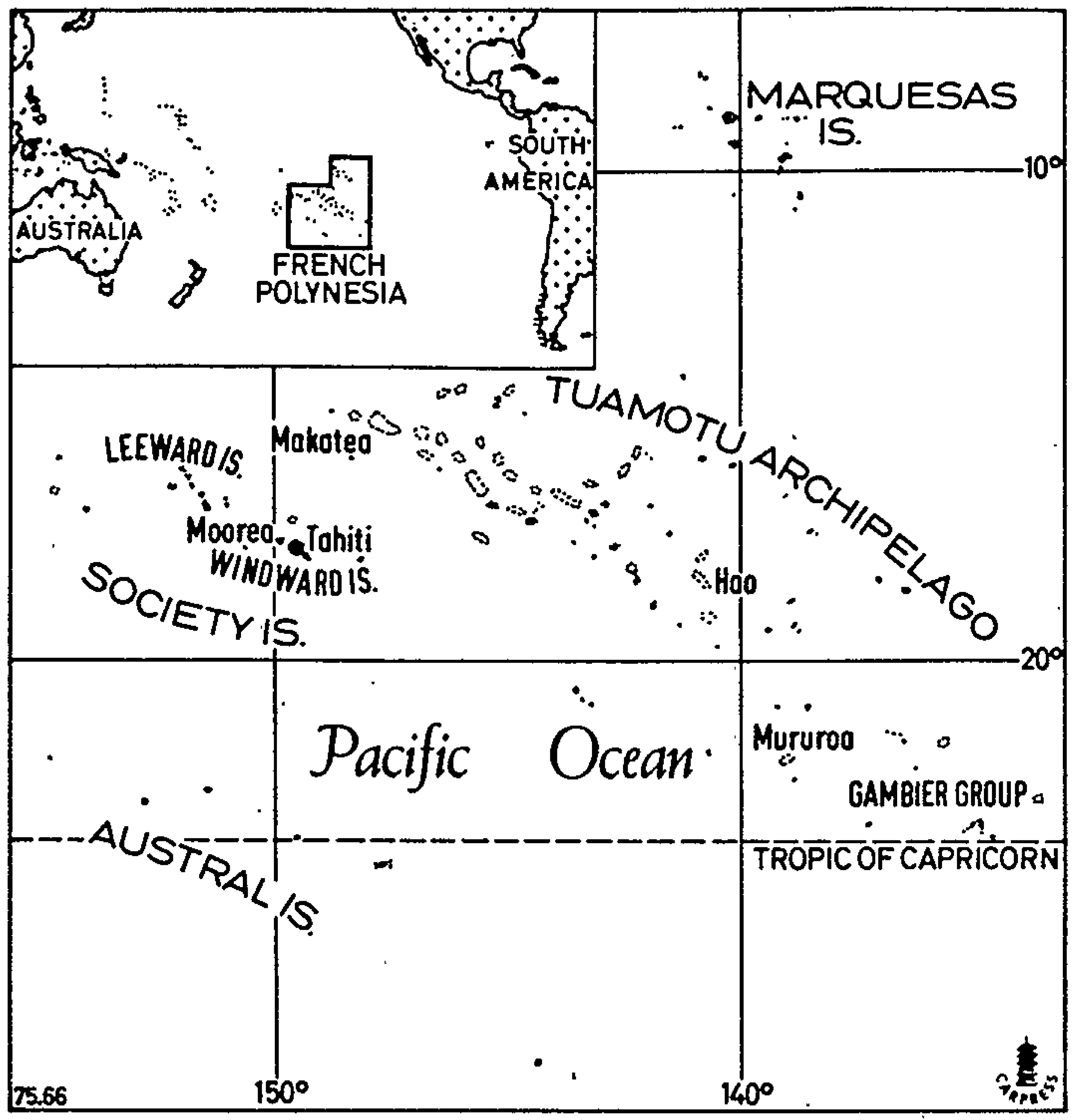
The Tax System of Tahiti (French Polynesia)

– A Brief Survey –

By Eugen Jehle

Mr. Jehle is senior research associate of the International Bureau of Fiscal Documentation.



I. INTRODUCTION

(a) General information[1]

Tahiti (French Polynesia) is a group of some 130 islands situated in the South Pacific[2] with the political status of an overseas territory of France (territoire d'outre-mer).

Tahiti has about 150,000 inhabitants who live on some 117 islands (land area about 4000 km^2) which are scattered over an ocean area of 4 million km^2.

The legislative authority for Tahitian affairs (including tax matters) is the Territorial Assembly (Assemblée Territoriale de la Polynésie Française), the members of which are elected by popular vote.

(b) Fields of industrial and commercial interest in Tahiti

The major sectors for entrepreneurial activities include the following:[3]

(1) *Tourism*

At present, tourism is the most important part of the economy of Tahiti. In 1982, 113,924 persons visited the archipelagos of Tahiti, and this number is expected to increase further in 1983 and in subsequent years. In order to cope with the rapidly increasing interest, the tourism industry will be further developed, particularly through the construction of new hotels in somewhat remote archipelagos, the promotion of a more diversified accommodation structure, and the development of activities linked with the hotel business.

(2) *Exploitation of maritime resources*

Given the vast maritime "area" that constitutes Tahiti, there are splendid opportunities for development in the long run, particularly with respect to deep sea mining and the production of marine proteins at a very large scale.

In the short run, the further development of shrimp and oyster farming, the promotion of the "Tahiti black pearl", the establishment of a fishing fleet, and construction of necessary processing facilities is envisaged.

(3) *Agriculture*

In this area, emphasis is currently being put on the expansion of livestock production in order to reduce the present high level of meat product imports.

Moreover, the further development of activities such as the production of vanilla, flowers, pineapples, mangos

1. For an English language survey containing general information on Tahiti, see: J. Carter (ed.), *Pacific Islands Yearbook* (Sydney and New York: Pacific Publications).
2. In fact, Tahiti is the major island in the group of 5 archipelagos with some 117 islands; the official name of the group is French Polynesia. However, since the term "Tahiti" is usually employed as a synonym for all islands of French Polynesia, reference is made to this term in this survey.
3. This summary is based on information contained in: *Investment in French Polynesia,* published by the Bureau de Développement (see also: III.).
General information on investment opportunities in Tahiti (French Polynesia) is available from, inter alia:
Office de Développement du Tourisme (O.D.T.)
Bd Pomaré,
B.P. 65
Papeete, La Polynésie Française
Tel: 2 96 26 – Telex: OFFTOUR 254 FP

Service des affaires économiques
Fare Ute,
B.P. 82
Papeete, La Polynésie Française
Tel: 2 65 23; 2 61 17 – Telex: DEVPOL 265 FP

and other fruits is being encouraged to satisfy the increasing demand for them in the area.

(4) *Industry and the field of real estate*

Naturally, industries that are closely linked with the areas cited above play a most important rôle. This also includes the Tahitian building industry which has to satisfy the growing interest in real estate located there.

II. THE DIFFERENT TAXES OF TAHITI (FRENCH POLYNESIA)[4]

(a) The company income tax
(Impôt sur les bénéfices des sociétés)[5]

In general, all (resident) companies that have their seat in Tahiti as well as non-resident companies that maintain any activity there, are subject to this income tax.

Exempt are certain specialized financial institutions, farmers associations, and state, territorial or municipal bodies.

The taxable base is defined as the profit calculated according to well established accounting rules, namely the application of the accrual method. Thus, capital gains derived by companies are, in principle, included in the taxable base.

Losses may be carried forward for 5 years.

The rate of the tax is fixed at a flat 30%. Companies with an annual profit exceeding certain amounts are, in addition, subject to the territorial solidarity tax and the extraordinary solidarity tax.[6]

(b) The tax on movable property
(Impôt sur le revenu des capitaux mobiliers)[7]

This tax is imposed on a company's distribution of profits and attendance fee payments as well as on the interest payment on bonds (unless the payment is made to a bank).

This tax is also imposed on profits derived by a (non-resident) company with its head office in mainland France that maintains any activity in Tahiti; the actual amount that is taxed is calculated on a pro rata basis. Accumulated profits are thus exempt from this tax.

This tax is generally levied at the rate of 10% (12% in case of prizes on premium bonds) and it is borne by the recipient; the actual payment is, however, made by the paying company by way of withholding the tax at source.

(c) The tax on transactions
(Impôt sur les transactions)[8]

This tax can be characterized as a tax on gross income (which, however, has some features of a turnover tax although the tax must be explicitly excluded from the sales price of commodities or services).

Liable to this tax is any recipient of money (except wage earners and farmers) who is not subject to the company income tax; this includes revenue from commercial activities, liberal professions and rentals.

The applicable tax rate is levied on the amount of revenue (rather than the amount of net income). It varies between 1 and 3% in case of revenue from commercial activities, and between 2 and 6% in other cases.

Certain exclusions, reductions and tax rebates are available in specific cases, e.g. low-profit activities.

The only full tax exemption is granted for revenue that results from export activities.

(d) The trade tax
(Contribution des patentes)[9]

All those persons who carry on a commercial activity are subject to this tax (wage earners, farmers, artists, teachers, fishermen, etc. are not subject to the tax).

The trade tax is composed of two elements:
(a) a fixed tax of which one component is determined by the type of activity and the other by a number of variable components; in the latter case, the number of employees is the most important factor;
(b) a proportional tax based on the rental value of the professional establishment; the rate varies between 2% and 28%.

The second element is the more important.

A surtax is levied on the trade tax, the revenue of which is destined for the Chamber of Commerce and the municipalities.

Some municipalities levy an additional tax on the rental value of professional establishments.

(e) The real property tax
(Impôt foncier sur les propriétés bâties)[10]

All types of buildings are subject to this tax; land is subject to this tax only if it is used for industrial or commercial purposes.

Certain exceptions and exemptions are provided for.

The taxable base is the assumed income from the real property which is determined as 75% of rental value. Where real property is rented out, the actual revenue is the taxable base.

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4. This brief survey is based on the documentation as contained in Contributions directes et taxes assimilées, Recueil de Textes (Imprimerie Officielle, Papeete).
5. Resolution concerning company income tax, 1959, No. 59-5 (Impôt sur les sociétés), and amendments.
6. See (i) Other taxes, below.
7. Resolution concerning income tax on movable property, 1956 (Impôt sur le revenu des capitaux mobiliers), and amendments.
8. Resolution concerning tax on transactions, 1968 No. 68-4 (Impôt sur les transactions), and amendments.
9. (a) Resolution concerning trade tax, 1958 (Contibutions des patentes), and amendments; (b) Resolution concerning the tax on the rental value of professional establishments (Taxe sur la valeur locative des locaux professionnels), and amendments.
10. Resolution concerning the real property tax, 1959 (Impôt foncier sur les propriétés bâties) and amendments.

The rate of the real property tax is 10%; municipalities may levy a surcharge of up to 50% thereon (thus a maximal tax burden of 15%).

(f) The beverage licence duty (Contribution des licences)[11]

Entrepreneurs who sell or serve beverages are subject to the beverage licence duty.

The amount of the duty due depends on the category of beverages as classified and the zone in which they are sold or served; it varies and may go up to 100,000 FCP per annum.

A surcharge is levied on the beverage licence duty, the revenue of which is destined for the Chamber of Commerce and the municipalities.

(g) The apprenticeship duty (Taxe d'apprentissage)[12]

Employers that maintain commercial activities are subject to apprenticeship duty.

The amount of the duty due is fixed at 5,000 FCP per annum and per employee. Exemptions may be applied for where specific training is offered to employees by the employer.

(h) The entertainment tax (Taxe sur les spectacles)[13]

This tax is levied in different manners: on a lump sum basis (2,000 FCP) in case of evening events where beverages are served, or at different rates in case of movie presentations where the actual tax rate depends on the classification of the films: 0% for films with no restriction as regards age, 50% for other movies or "closed" presentations, and 12.5% for films with specific restrictions.

Moreover, through Resolution No. 83-10 of 6 January 1983, an amount of 50 to 200 FCP per film (depending on the classification) is due for the leasing of video cassettes or video discs.

A great number of exceptions and exemptions are provided for.

(i) Other taxes

There are three more levies in the tax system of Tahiti which are worth mentioning:

- The territorial solidarity tax[14] is charged on those companies that are subject to the company income tax whose turnover of the preceding year exceeds 200 million FCP in case of commercial activities and 50 million FCP in case of service activities. The rate of this tax is fixed at 8% of the taxable profit of the financial year in question.
- The extraordinary solidarity tax[15] is levied for the fiscal years 1982 and 1983 on profits of companies whose annual taxable profit amounts to 100 million FCP or more. The rate of this tax is fixed at 10% of the taxable profit.
- The tax on under-valued rural property[16] is of minor significance and is mentioned here only for the sake of completeness.

It must again be noted that there is a number of surcharges on various taxes; they are, however, mentioned in the context of the main tax (see above).

III. FINAL REMARKS

The most important feature of the tax system of Tahiti must be seen in the fact that there is no general individual income tax. Indeed, wages and salaries are not subject to tax, nor are capital gains realized by individuals.

Moreover, a great number of fiscal incentives is offered for investments through enterprises. The relevant legislation, namely the Investment Code (Code des investissements de la Polynésie Française) is reportedly under revision at present; the *Bulletin for International Fiscal Documentation* will report on this Code in due course.

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11. Resolution concerning beverage licence duty, 1958, No. 15/1958 (Contribution des licences), and amendments.
12. Resolution concerning the apprenticeship duty, 1964, No. 64-8 (Taxe d'apprentissage), and amendments.
13. Resolution concerning the entertainment tax, 1950 (Taxe sur les spectacles), and amendments.
14. Resolution concerning the territorial solidarity tax, 1975 No. 3230 (Prélèvement territorial de solidarité), and amendments.
15. Resolution concerning the extraordinary solidarity tax, 1982, No. 82-4 (Prélèvement exceptionnel de solidarité), and amendments.
16. Resolution concerning the tax on under-valued rural property, 1953, Arts. 1 to 9 (Impôt sur la propriété rurale non ou insuffisament mise en valeur), and amendments.

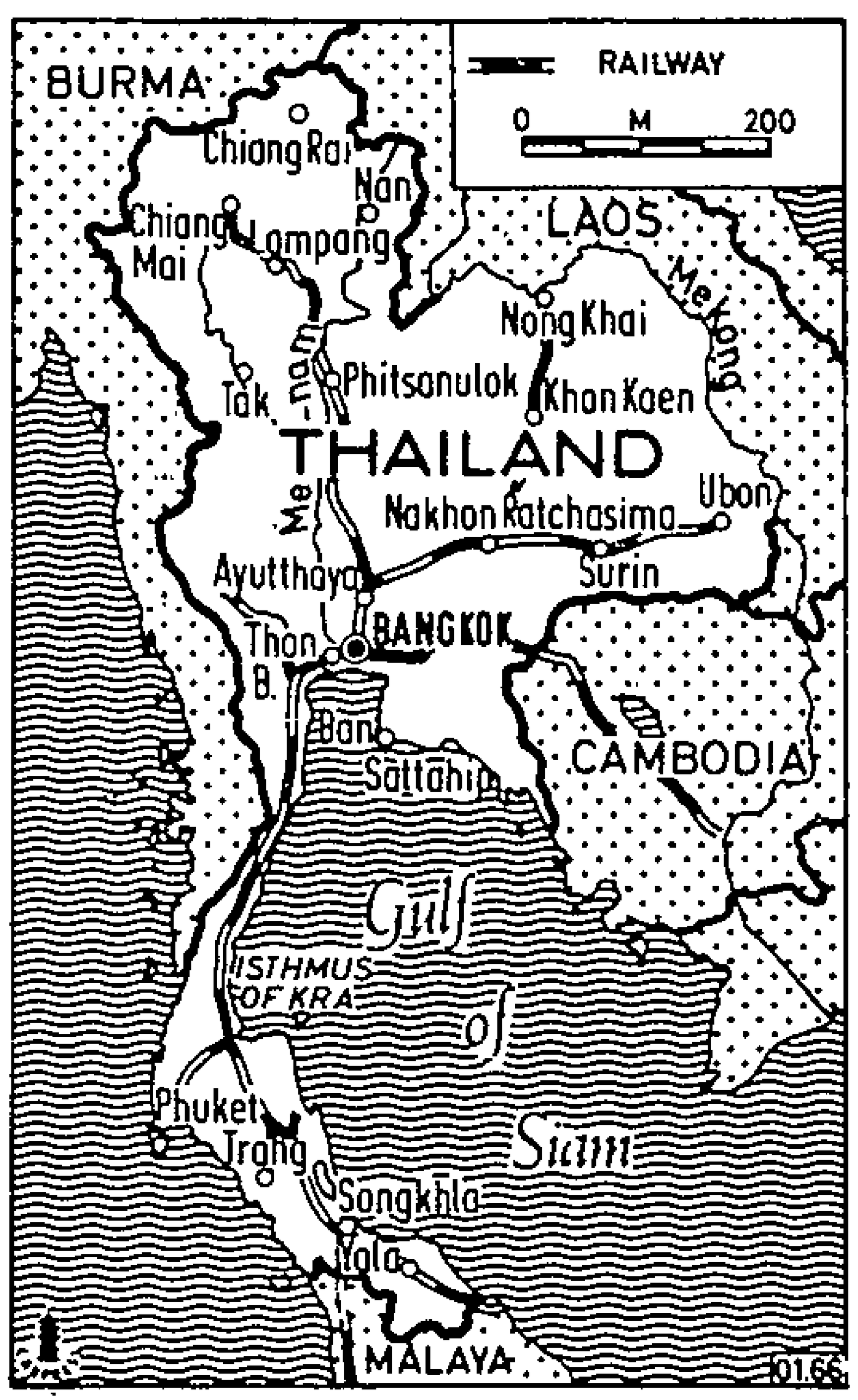
THAILAND:
Recent Developments and Problems Relating to the Taxation of Multinational Companies

Working Paper presented at the 12th Meeting of the Study Group on Asian Tax Administration and Research (SGATAR) 7-12 June 1982, Kuala Lumpur, Malaysia.

1. INTRODUCTION

1.1. Multinational company: concept and definition

The term "multinational company" is, generally, used to refer to a company that operates in several countries through affiliates that are subject to some degree of central control. The influence of the parent company may take on several forms, including control over such strategic aspects of the affiliate's operations as pricing policies, choice of technology, appointment of key personnel and determination of markets. Normally, a multinational company (MNC) is characterized, first, by having control over huge financial and technological resources; second, by possessing the ability to control the market; third, by having the capacity to produce a wide variety of products; fourth, by being able to utilize advantageous situations in various countries; and finally, by having the ability to utilize world resources in various regions most efficiently. All these characteristics are utilized for the purpose of achieving the company's goal.



Thai tax law does not define the term "multinational company". All companies, whether multi-national or uni-national, are treated equally for tax purposes.

In Thailand, a multinational company could be a Thai company carrying on business in other countries or a foreign company carrying on business activities in Thailand through a branch or any other establishments of similar nature. A company is classified as a Thai company if it derives its juristic status from Thai laws. That is, if the company is registered in Thailand under the Civil and Commercial Code of Thailand, then the company is a Thai company. A company doing business in Thailand through a branch not registered in Thailand is considered a foreign company. At the present time there are very few Thai companies which can be classified as multinational companies. Thus, Thailand's major concern in this respect is with foreign multinational companies.

1.2. Role and impact of MNCs: Thailand's experience

It has been an accepted fact that multinational companies have played an important and sometimes controversial role in world economic development. There have been costs as well as benefits brought by the presence of MNCs, especially in developing countries. Thailand is no exception. MNCs have played an important role in modernizing and industrializing Thailand. We rely heavily on foreign investment by MNCs for our development. However, we have also sacrificed substantially for MNCs in terms of natural resources, cultural heritage and, of course, tax revenues.

At the present time, MNCs are very active in a wide range of industries such as oil exploration, refinery and distribution, automobiles, mining, petrochemicals, office machine, and textiles. They are very powerful and influential economically and politically. Whether the benefit derived from the MNCs is worth the sacrifices made by Thailand as the host country is still a debatable question.

2. TAXATION PROBLEMS AND ISSUES OF MNCs

All Thai companies are taxed on a global income basis whether they are national or multinational. The tax is based on profits and the rate is fixed at 40% for ordinary companies and 30% for registered companies (companies listed on the Security Exchange of Thailand). There is no legal distinction between a Thai company carrying on business solely in Thailand and an MNC carrying on business without as well as within Thailand. They have the same legal status, enjoy the same rights and are liable to the same taxes.

2.1. The arm's length principle and inter-company pricing

The arm's length rule specifies that all transactions between the headquarters and the affiliate or among the affiliates themselves should be done as if all these entities were distinct and separate enterprises. All pricing and other treatment should be charged and done the same way as it would be charged and done to a distinct and separate enterprise engaging in the same or similar activities under the same or similar conditions and dealing wholly independently of each other.

Transfer pricing is one way to siphon profit out of Thailand without paying tax. Some foreign MNCs import goods from their headquarters at inflated prices. This is not only a way to reduce profits of the branches or subsidiaries or other affiliates in Thailand in order to avoid profit tax, but also a way of transmitting profits to the headquarters without paying taxes on remittances of profits. This is because profits are transferred in the form of inflated cost prices. This practice is rather widespread among foreign multinational companies in Thailand.

Thai tax law has a provision to guard against this practice. Section 65bis(7) of the Revenue Code specifies that the assessment officer has the power to establish cost prices of imported goods by comparison with the cost price of the goods of the same category and type which are delivered to another country. It is very difficult, however, to put this power into practice since cost prices in the world market are either non-existent or not easily obtainable.

In some cases, the affiliate exports goods to the parent company at a price lower than the market price so that more profit may be attributed to the parent company and less profit is left for the branch or subsidiary. This is to avoid tax in the host country. In this case, the Revenue Code of Thailand also has a provision to prevent this practice. Section 65bis(4) of the Revenue Code empowers the assessment officer to establish prices at the market value on the date of transferring goods if he sees that goods are transferred, without justifiable ground, at a price lower than the market value.

2.2. Transfer of trading stock between parent and subsidiary companies

Another common practice of MNCs in avoiding taxes is to transfer trading stock from the subsidiary to the parent company without compensation or charges. This can be done under the disguise of sending "samples" or goods sent out for advertising purposes. In effect, this is a transfer of profit from the subsidiary to the headquarter company. Other than trading stock, the objects of transfer could be in the form of services rendered without charge or money lent without interest. Thai tax law has a provision to prevent this practice. Section 65bis(4) of the Revenue Code states that in the case where, without justifiable ground, property is transferred, a service is rendered, or money is lent without any compensation, service charge or interest, or with a compensation, service charge or interest in an amount lower than the market value, the assessment officer has the power to assess the compensation, service charge or interest at the market value on the date of transfer, rendering the service or lending.

2.3. Banking and transfer of funds across international boundaries – "Garnering" effect

Another way to avoid paying tax in a high tax country is to gather funds in the form of a loan to the subsidiary in the country where the tax is high. Interest would be charged to the subsidiary, thereby reducing the taxable profit of the subsidiary. However, MNCs must consider the country's withholding tax on interest remitted abroad. In the case of Thailand, interest paid to a foreign company is subject to a 25% tax rate. Thus it is worthwhile to keep funds in the form of loans to the subsidiary in Thailand since corporate income tax in Thailand is 40% on profit and 25% on profit remitted abroad. For example, if the interest is ฿ 1,000,000, tax on interest is ฿ 250,000 but the profit of the subsidiary would be reduced by ฿ 1,000,000 and tax on profit would be reduced by ฿ 400,000 plus a reduction of tax on remitted profit of ฿ 120,000 ($^{25}/_{125} \times 600{,}000$). Therefore, the net gain in tax is ฿ 270,000.[1]

However, this may be done only in the case where MNCs have subsidiaries in Thailand. If the affiliate is in the form of a branch it may not be done. Since the headquarters and the branch are considered the same company by the laws of Thailand, it is construed that this interest is paid to the company's own funds. Thus, deduction of the interest violates Section 65ter(10) of the Revenue Code which specifies that no consideration for the properties owned and used by the same company shall be allowed as expenses. Moreover, Section 65ter(11) specifically prohibits deduction of interest on capital, reserves or funds of the company.

2.4. Allocation of overhead expenses

Strictly speaking, under Thai tax laws, overhead expenses of the headquarter may not be deducted from profits of the branches. This is because Section 65ter(14) of the Revenue Code prohibits deduction of any expenses not exclusively expended for the purpose of business in Thailand. In auditing foreign MNCs, one quite often finds that profits are reduced for the purpose of avoiding taxes, by deduction of expenses such as research and administrative expenditures of the company headquarters from the profit of the branches. In this case not only is corporate income tax avoided, but also personal income tax. This is because expenses claimed as administrative and research expenditures of the headquarters include salaries of executives working in branches in Thailand. Since the salaries are not paid in Thailand, it is not possible to withhold taxes from these salaries.

The deduction of research and administrative expenditures of the headquarters from the profits of the permanent establishments located in Thailand, however, is allowed if the company is incorporated in a country with which Thailand has signed an Agreement for the Avoidance of Double Taxation. This is because the Article of the Agreement concerning business profits usually allows those expenses as deductions, whether they are incurred in Thailand or elsewhere.

2.5. Loss companies – companies showing continuous losses or low profits

Thai tax laws do not have a provision to guard against companies showing continuous losses or low profits. That is, all companies are subject to tax on profit. The tax base is profit. If the company operates at a loss, the company does not have to pay tax, no matter how frequent or severe the loss is. Moreover, losses may be carried forward for 5 years. The only measure that the tax administrator has for dealing with continuous loss or low profit companies is to make an audit of the company's accounts. The method of taxing a percentage of the gross contract price is not available for use with loss companies. In Thailand, this method is used for some other purposes. Section 71(1) provides that if any company fails to file a tax return or fails to keep all or any of the required accounts or fails to produce accounts required by

1. Editor's note: Cf. 2.6. below.

the assessment officer for examination, the assessment officer has the power to assess tax at the rate of 5% on the aggregate of either the gross receipts or the gross sales for the accounting period before deduction of expenses. This provision of law is used when the profit is not ascertainable. Once tax is paid according to this provision, they are not liable to tax on remittance of profits.

2.6. Remittances of profit by way of royalties, licence fees, etc.

One way to avoid paying high tax on profits is to remit profits in the form of royalties or licence fees. Under present Thai tax law, royalties are subject to the 25% withholding tax whereas profits are subject to a 40% tax and another 25% tax on profit remittances. Moreover, royalties are considered as expenses of the company. Thus an MNC may arrange with its subsidiary to charge royalties or licence fees at a higher rate or to charge a fee which normally would not be charged. If the royalty charge is ฿ 1,000,000, the tax on royalties is ฿ 250,000. However, the subsidiary may claim royalty expenses, thereby reducing the profit of the subsidiary by ฿ 1,000,000. The tax on this ฿ 1,000,000 is ฿ 400,000. Moreover, this ฿ 1,000,000 is transmitted to the headquarters without paying the 25% tax on remittance which amounts to $^{25}/_{125} \times 600{,}00 =$ ฿ 120,000. The total tax of the company on this ฿ 1,000,000 would be ฿ 520,000 if it were transmitted as profits. However, if it were disguised as royalties, the tax would be ฿ 250,000. Thus the MNC can save ฿ 270,000 through this arrangement. This practice does not conform to the arm's length principle and is against Thai tax law, as stated earlier.

Thailand has had another interesting experience concerning tax on royalties. In Thailand, the import of certain commodities is subject to a very high rate of customs duty and it pays the taxpayer to disguise part of the price of his imports in the form of royalties. For example, an item imported may be subject to a 70% customs duty. If the actual price at c.i.f. of the import is ฿ 1,000,000, the taxpayer may understate the price as being only ฿ 600,000 and claim that there is a royalty charge of ฿ 400,000. The customs duty paid is then ฿ 420,000 and tax on royalty ฿ 100,000. The taxpayer, then, pays a total of only ฿ 520,000 to the government. If part of the price was not disguised as a royalty then that taxpayer would have had to pay the Government a total of ฿ 700,000. Thus, the taxpayer would save ฿ 180,000 through this arrangement. Measures have already been taken to plug this loophole.

2.7. Multinational shipping companies

To avoid difficulty in the determination of profit attributable to the carrying of passengers and cargo from Thailand, Thai tax law provides for a tax on gross receipts. Section 67 of the Revenue Code specifies that, in the case of carrying passengers, tax is at the rate of 3% of fares, fees and any other benefits collectible in Thailand before deduction of any expenses. In the case of carrying goods, tax is at the rate of 3% of the freight, fees and any other benefits collectible whether in Thailand or elsewhere in respect of transport of goods from Thailand before deduction of any expenses. Note that the tax rate is 3% for carrying both passengers and cargo, but the criteria for the imposition of tax are different. In the case of passengers, the tax is imposed on sales of tickets collectible in Thailand. In the case of cargo, tax is imposed on the outgoing freight wherever collectible. Nowadays, shipping companies are mostly engaged in cargo rather than passengers. Thus, loosely speaking, it could be said that taxation on multinational shipping companies is 3% of the gross amount of outgoing freight from Thailand.

2.8. The effect of domestic tax shelters on other countries

Tax shelters in Thailand cover corporate income tax, personal income tax, business tax as well as customs duty. The law giving a tax shelter is the Investment Promotion Act. The shelter includes exemption of tax on profits for a period of 3 to 8 years starting from the date that revenue is generated from the promoted activities; the exemption of tax on dividends and royalties received from promoted companies; exemption from or reduction of customs duty as well as business taxes. These tax shelters are designed to induce MNCs to invest in Thailand. The problem is whether the tax shelters available in Thailand can be utilized to operate to the fiscal disadvantage of other countries. All other things being equal, naturally the MNCs will try to shop for a country with the best tax treatment. If the tax shelter in Thailand is better than other countries in the same region it would put those countries in a disadvantageous position. The normal reaction is competition among countries in the same region to give a higher degree of tax shelter. The result is that developing countries suffer the MNC's gain from such competition.

3. CONTROL OF MNCs AND EXCHANGE OF INFORMATION

3.1. Control of MNCs

MNCs are quite free in Thailand. They are not subject to control by the government nor by any governmental agencies. As far as taxation is concerned, they are treated in the same manner as other domestic companies.

3.2. Exchange of information

Under the double taxation agreements between Thailand and other countries, the article on exchange of information is conventional. Thailand follows the OECD and U.N. models concerning this Article. Thus the exchange of information between Thailand and her treaty partners is theoretically quite generous and cooperative. However, in practice, very little information has been exchanged. At the present time, among the SGATAR member countries, Thailand has signed and ratified treaties with Japan, Singapore, Indonesia and Korea.

For countries without double taxation agreements with Thailand, exchange of information is not possible. This is because Thai tax law prohibits revealing taxpayer information. Section 10 of the Revenue Code states that an officer who has, by virtue of his office, acquired information on the business of a taxpayer or of any other person concerned shall not divulge or otherwise communicate such information to any person, unless authorized to do so by law.

3.3. Suggestion for improvement of arrangements for the exchange of information

Exchange of information is one way to prevent fiscal evasion. SGATAR member countries with double taxation agreements among themselves should put more effort into and be more cooperative in utilizing the exchange of information provision of double taxation agreements.

This can be done through establishing a standing committee to take care of this matter regularly. The committee should set the rules and regulations for implementation of the exchange of information provisions, promote and motivate exchange of informtion, and arrange a constant flow of information among member countries.

Tax Changes in a Low Tax Country: The 1983-84 Budget in Bermuda

By H.W.T. Pepper

In presenting his Eighth Budget in the Bermudian House of Assembly on 25 February 1983, the Honourable J.D. Gibbons, J.P., M.P., Minister of Finance, also reviewed the well-organized Bermudian economy.

The country, in recent years, has had basically balanced Budgets, reasonably full employment, and a healthy tourist industry, which is almost as important as the financial and insurance sections of the business sector in which Bermuda specializes.

The world recession has hit most countries' tourist industries but Bermuda still managed around 420,000 tourist arrivals in financial year 1982-83, plus 127,000 cruise ship passengers, and hopes to increase the figures to 450,000 and 130,000 respectively in 1983-84 – about 10 times the Bermudian population.

The growing pressure by Governments in industrial countries to restrict their own corporate sectors' efforts to set up offshore operations which defer or reduce their local tax liabilities (even where such operations are real and substantial, rather than merely artificial transactions solely designed for tax avoidance or deferral) has begun to reduce the revenue of some low tax countries. Bermuda, however, which is an exceptionally respectable and sophisticated financial centre, expects to achieve a modest expansion in revenue from the financial sector, and a small Budget surplus in 1983-84.

Bermuda has a per capital income among the highest in the world. Among the projected Departmental expenditures for 1983-84 listed in the Budget is a sum of $26.9 million for education ($487 per head of the population, and over $2,000 per head of the school and college students). The increased expenditure in 1983-84 is partly to finance an extension of the teaching of computer technology, a far-seeing provision to fit school leavers for white-collar jobs that will increasingly involve computerization. While there is a separate medical insurance scheme for the adult population, there is still a massive $33.5 million ($605 per head of the population) allocated to the Ministry of Health and Social Services, while the Ministry of Works, Housing, Agriculture and Fisheries is allocated $19.2 million, a good deal of which goes into housing. There is also a substantial budget of $13.3 million for tourism, a realistic acknowledgement of the importance of providing and maintaining good facilities for this important "industry".

The fiscal changes in the current Budget are basically an indexing operation. Postal charges were due for updating and this is to be implemented in respect of overseas mail.

Customs duties on imported alcohol, cigarettes, and hydrocarbon fuels (gasoline and diesel) are all imposed as specific duties on volume or weight and are naturally due for increases which are duly made. The exception, the ad valorem duty on wines, is amended by increasing the maximum *valuation* which may be applied from $2.25 to $3.55 per litre.

A minor increase is the $5 addition to passenger tax. The major operation, the 15% increase in *yield* from property tax, projected in last year's Budget is already in effect but the accompanying valuation exercise and consideration of appeals is still in process. The revaluation will, of course, alter relative tax charges where values have varied at different rates between different properties since the last valuation, but it has been made plain the total tax yield increase will not exceed 15% as a result of the operation so that those in humbler homes will have smaller increases than those in more magnificent mansions. The principle of graduated rates of tax charged on the property value is, of course, a further benefit to those in lower income groups living in more modest houses and this system is not being changed.

BERMUDA:

Budget 1983-84

Extracts from Budget Speech pronounced on 25 February 1983 by the Honourable J.D. Gibbons, J.P., M.P., Minister of Finance

TAX CHANGES

As is customary, the expenditure estimates make no provision for wage and salary increases for government employees yet to be agreed. Funds will also be required to increase the capitalization of the West End Development Corporation as it steps up its activities. On the other hand, the uncertain prospects for the world economy at this time make the revenue estimates more than usually tentative. I therefore consider it prudent at this stage to make some provision for higher than expected spending and lower than projected revenue.

Thus, I am also recommending some further changes in taxation. Honourable Members will appreciate that just under one quarter of Customs receipts are charged on a specific or volume basis and do not rise automatically with inflation. In a period where strong growth has led to increases in revenue from other sources, the need to index receipts from specific duties is less acute. however, these favourable conditions no longer prevail and I intend to take measures to restore at least part of the real value of receipts from this source.

In accordance with the provisional Collection of Customs Duties Act 1960, I have to day laid before the House a Bill providing for the following increases in import duty:

- Spirits: $2.25/litre of alcohol
- Beer and cider: 3¢/litre
- Cigarettes: $2.5/kg
- Gasoline: 3¢/litre
- Diesel fuel (other than supplied to BELCO): 3¢/litre

The maximum value on which wine is charged with an ad valorem duty will also be increased from $2.25 to $3.55 per litre. The increases will take effect immediately.

The additional revenue arising from these increases is expected to be just over $2.7 million. The increases in duty are equivalent to about $1 per litre bottle of spirits, up to $1 per litre on fine wines, 1¢ per can of beer and 5¢ per packet of cigarettes. Increases in the retail price of these itms in excess of these amounts cannot be attributed to the higher duty and I trust that sellers of alcohol and cigarettes will follow the practice of the two local oil companies in raising prices by the increase in duty only.

In my last Budget Speech I announced that discussions would be held with the international companies with a view to their paying employment tax. This proposal met with a good deal of resistance, the companies arguing that to subject them to the tax would be regarded as a breach of the spirit, if not the letter, of the tax assurance given by the Exempted Undertakings Tax Protection Act 1966. While I cannot feel too much sympathy for this argument, it has to be recognized that the local taxation of international companies is just as much an aspect of Bermuda's competitiveness as is any other local cost. I have come to the conclusion that it would not be advisable to press ahead with the proposal. Nevertheless, in place of an assurance that exempted companies will not be subject to employment tax, the assumed level of annual remuneration per employee on which the companies are charged Hospital Levy will be raised from $21,000 to $30,000. Moreover, this amount will henceforth be indexed each year in April on the basis of the change in the retail price index over the year ending the previous December. The initial increase in tax arising from this measure will amount to about $600,000 per year.

Taken together, these tax changes will therefore yield additional revenue of $3.3 million, or just under 2% of the total $165 million shown in the estimates.

LAND TAX AND LAND VALUATION

As was foreshadowed in may Budget Statement last year, an across-the-board 15% increase in land tax rates took effect in January. At the same time partial relief from tax was given to Bermudian owner-occupiers 65 years of age or older who formerly did not receive an exemption.

as Honourable Members are aware, the ARVs published in the draft valuation list released last october revealed what to many people was a surpingly large general increase in assessments. Concern was widespread that as a result of the new valuations the tax burden faced by property owners would increase dramatically, not only by a factor equivalent to the rise in the assessment, but also as a result of the property moving into a higher tax bracket. Furthermore, it was not generally appreciated that the limits for rent control and the pensioner concession would be adjusted to maintain the status quo.

At a press conference on 21st October, my colleague, the then Minister of Works, Housing, Agriculture and Fisheries, reiterated my assurance that, apart from the 15% rise first announced last February, there would be no overall increase in tax collected as a result of the introduction of the new valuation list. He also expressed the Government's concern that the new valuations, being based on open market rentals which, in the case of owner-occupied properties and those subject to rent control are, of necessity, hypothetical, might be used as a lever to raise rents in the controlled sector of the market. He suggested that in order to minize this possible inflationary impact the Government would examine the new valuations with a view to implementing a general reduction in the level of ARVs. later it was suggested that there might be an advantage in expresing the assessments in index form so as to distance them from the notional open market rentals on which they are based.

Temporary legislation was enacted empowering the Minister responsible for Land Valuation to decide on the operative date of the new list without prejudice to its formal adoption by the Land valuation Appeals Tribunal. The original objection period was also extended for a further two months.

I hardly need remind this House that for revenue purposes it matters not one iota whether the general increase in assessments between valuations is 50% or 500% as the tax rates will be appropriately adjusted to produce the desired revenue. In considering a general reduction in values, or an index-based alternative, it has never ben Government's intention to disturb nthe relativities established in the new list. Not only would such action defeat the whole purpose of the valuation exercise – which is to capture recent trends in the market and so maintain a tax base which is equitable – but it would be quite improper for the Government to interfere in what is a statutory, independent exercise. The change in relative valuations proposed in th new list will, in effect, be confirmed or adjusted by the Land Valuation Appeals Tribunal in dealing with objections in the usual manner. Thus, subject to the eventual confirmation of the list by the Tribunal, I must tress that neither the total tax collected, nor its distribution between taxpayers, will be affected by any subsequent general scaling of assessments intended to minimize the possible inflationary impact of the new list.

The Government appreciates that some taxpayers may have decided not to pursue an objection to an assessment pending the Government's final decision regarding the new list. They may now feel they have been misled into missing the boat. However, it must be appreciated that the new valuations are not immutable. Where a taxpayer is genuinely concerned that the assessment on his property is inconsistent with that on similar properties or otherwise incorrect, he can be assured that the Land Valuation Office will treat such cases sympathetically and, where justified, propose an appropriate change to the ARV. Moreover, I will shortly be publishing the tax rates, rent control limits, and Bermudian pensioner allowance, which the Government will propose should it be decided to proceed with the new valuation list in its present form. May colleague, the Minister for Home Affairs, is presently considering what limits will apply in the case of land sales to non-Bermudians.

In general, the new valuation list reveals a somewhat larger increase in assessments on higher valued properties than on lower valued properties. Hence, as a result of the changes in relativities established in the new list the burden will, in general, be further shifted toward the top end of the scale. Broadly speaking, owners of higher valued properties will incur a greater tax liability, while owners of more modest properties will find their future tax bills reduced compared with those sent out last month. However, there will inevitably be exceptions to this general movement.

Again, I would stress that no general increase in revenue will be brought about by the introduction of the new list. The 15% increase in tax announced last February is already in effect.

THE PHILIPPINES:

Recent Developments and Problems Relating to the Taxation of Multinational Companies

Working Paper presented at the 12th Meeting of the Study Group on Asian Tax Administration and Research (SGATAR) 7–12 June 1982, Kuala Lumpur, Malaysia.

INTRODUCTION

At the outset, we have to consider that multinational corporations have their own global business objectives of varying dimensions and directions, and in a number of instances, some of these global objectives do not coincide with the national objectives of the countries where they operate. Like individuals, multinational corporations are of different moulds. Some adhere strictly to a pattern of conduct. Others simply behave as they see fit, following the maxim: the end justifies the means. It may be conceded that the latter category of multinationals does not represent a predominant number, but the unwholesome practices of a few are usually the only items that are exposed and given extravagant publicity. Consequently, whether rightly or wrongly, there has been a growing apprehension in both developed and developing countries that multinational corporations pose political, economic and social threats of varying magnitudes.

Governments of less developed nations grappling with the problems of poverty, unemployment and social and economic inequalities are generally attracted by the package of resources and capabilities provided by multinational corporations – their huge financial capital, their technology, and their managerial and marketing skills.

The Philippine policy with respect to multinational corporations has definitely been one of attraction. We started this policy with the enactment of the Investment Incentives Act in 1967, although we were not initially successful in attracting foreign investments because our policy then was somewhat ambivalent. It was not until the inception of the New Society in 1972, when peace and order had tremendously improved and a clear policy was adopted by the administration towards foreign investments, that they started coming in heavily.

In response to attractive incentives, including fiscal incentives, many multinational enterprises have come to the Philippines. The expectation is that these multinationals would contribute significantly to industrial progress. After all, they are the most effective and powerful carriers of "modernization". They are the agents for linking the host, less developed countries, and world

economy. They are the most powerful collections of managerial and technical skills in the world. Their ability to tap financial, physical and human resources around the world and to combine them in economically feasible and commercially profitable activities, together with their capacity to develop and supply new technology and skills, translate resources into output and to integrate product and financial markets throughout the world, has proved to be outstanding.

Multinational company: concept and definition

The term "multinational corporation" broadly refers to a network of enterprises which control assets – factories, mines, sales offices and the like – in two or more countries. They are enterprises which own or control production or service facilities outside the country in which they are based. They exercise significant market control in some sectors of the economy, have a home base from which control or direction emanates, and derive a significant proportion of total income from overseas operations. They are foreign firms or entities engaged in international trade with affiliates, subsidiaries or branch offices. The term "affiliate" includes dealers or distributors of the foreign entity granted franchise or contract for the sale or distribution of its goods or services.

Role and impact of multinational corporations in the Philippines

From the "Top 1,000 Corporations in 1980" prepared and published by the Securities and Exchange Commission, it was gathered that there were 28 foreign investor groups, classified according to nationality, which have equity investments in the country. The top twelve investors and the number of firms which made investments are:

1.	American	172
2.	Japanese	57
3.	British	30
4.	Chinese	14
5.	Swiss	9
6.	German	8
7.	Spanish	6
8.	Canadian	6
9.	Belgian	4
10.	Dutch	4
11.	Luxembourg	4
12.	Panamanian	4
		314

The study further showed that at the close of 1980, the equity contributions of 277 trading investors reached ₱6,010 million, representing more than one third or 39.28% of the 277 firms' total paid-up capital of ₱15,299 million. This also accounted for 16.43% of the Top 1,000's aggregate paid-up capital of ₱36,799 million in 1980.

American corporate and individual investors contributed ₱3,439 million, a hefty 56.9% of the total foreign interest in the 277 firms. This represented 30% of the total paid-up capital of ₱11,499 million of the 148 firms with American equity.

A far second were the Japanese with investments of ₱1,242 million, accounting for 21.09% of the ₱5,891 million paid-up capital of 57 firms. Coming in third were the British with ₱340.955 million capital investment in 27 firms.

With most of Chinese businessmen in the country already naturalized, the Chinese ranked only fourth with ₱57.119 million invested in 14 firms.

Sectoral investments

By industry, the manufacturing sector received the bulk of foreign equity investments in 1980. The sector attracted more than half or ₱3,793 million of total foreign equity, with the American accounting for 60% or ₱2,296 million.

The Americans' presence in the manufacturing sector is most felt in the oil industry. Except for two companies, all the leading oil firms have American equity. A branch of an American company drilled the first commercial oil well in off-shore Palawan and is one of the more successful oil exploration firms in the country. American equity investments in these local oil firms at the close of 1980 came to about half a billion pesos.

The Americans are also well entrenched in the drug industry. Of the 25 drug firms which made it to the Top 1,000 in 1980, 15 were subsidiaries and branches of American multinationals. Until recently, the tire industry was also dominated by the Americans.

The financial sector drew the second biggest foreign equity investment, receiving ₱654.152 million or 10.83% of the total. Again the Americans were the biggest investors, accounting for a sizable 76.5% of equity. Of the five offshore banking units which were included in the Top 1,000 in 1980, four were Americans.

The other sectors and their corresponding foreign equity infusions were: mining, ₱593.217 million (9.81%); services, ₱477.277 million (7.94%); commercial, ₱382.609 million (6.37%); utilities, ₱89.885 million (1.49%); and agriculture, ₱19.85 million (0.33%).

Except for the mining and agriculture industries, the Americans had the biggest equity investments in all the sectors. The Canadians invested more than the Americans and the Japanese in the mining sector. The equity contribution of Canadians in two mining companies totalled ₱248.983 million as against the Japanese' ₱165.732 million and the Americans' ₱102.116 million invested in other mining outfits.

The Japanese, meanwhile, ranked first in the agriculture sector with ₱9.819 million in capital compared to the Americans with ₱7.307 million.

Sales. The 277 firms with foreign capital and the 34 branches of giant multinationals posted a combined turnover of ₱80,288 million in 1980, accounting for a hefty 45.04% of the top 1,000's total net sales of ₱178.251 million.

Combined profits of the group reached ₱2,372 million or 41.88% of the Top 1,000's net income of ₱5,662 million in 1980. Likewise, the ₱135,443 million resources of the group represented two-fifths of the Top 1,000's aggregate resources of ₱336,098 million at the close of 1980.

The preceding discussion shows the deep involvement of the multinational companies in the economic activities within the country. Their presence is particularly felt in the above-mentioned industry lines.

Tax treatment of subsidiaries and branches of foreign corporations

The local activities of multinationals are carried out in either of the following forms: (1) a wholly-owned or controlled domestic subsidiary; or (2) a local branch of a foreign corporation doing business in the Philippines. A law (PD 218) presents the possibility of another group – that of regional headquarters of multinational corporations. Without PD 218, this group would have fallen under the category of a local branch of a foreign country and would have been taxable as such. Another classification for tax purposes under which a foreign corporation could have investments in the Philippines is in the form of a non-resident foreign corporation.

A wholly-owned or controlled domestic subsidiary is, under our tax laws, taxable on world-wide income at rates applicable to domestic corporations in the same line of business. In fact, they are taxable as a domestic corporation since our tax law criterion for distinguishing between domestic and foreign corporations is based only on the law under which a corporation is created and organized; it does not at all utilize, at least for income tax purposes, the nationality of majority stockholders for this purpose.

A local branch of a foreign corporation doing business in the Philippines is subject to Philippine income tax as a resident foreign corporation. As such, it would be taxable only on its net income from within the Philippines, whether at the regular corporate rates of 25% and 35% or at some special rate, depending on the type of corporation. Resident foreign international carriers are subject to 2½% tax rate on their gross Philippine billings. This is equivalent to the imposition of a 25% tax rate on 10% of the domestic-source gross income of these taxpayers, thus pegging their deduction ratio to 90% of domestic-source gross income.

A multinational company whose investments in the Philippines are constituted merely by passive investments (i.e. they do not actually carry on business in the Philippines) are taxed on the basis of their gross income at a flat rate of 35%. However, this rate has been reduced to 15% with respect to non-resident foreign film owners, lessors, or distributors, and on interest on foreign loans or dividends received from domestic corporations liable to income tax if, in the last case, the taxpayer is allowed by the law of its home country to credit not only the tax actually paid but also that which would have been payable had the tax not been reduced.

TAXATION PROBLEMS AND ISSUES OF MNC

The arm's length principle

Under this principle, prices paid for goods transferred between associated enterprises should be, for tax purposes, those which would have been paid between unrelated parties for the same or similar goods under the same or similar circumstances. In contracts for licensing patents or know-how, the prices to be taken should be those which would be paid between independent enterprises acting at arm's length. Thus, if payments for the use of intangible property are deductible for tax purposes when made between unrelated parties, similar payments made in similar circumstances between associated enterprises ought to be treated similarly. On the other hand, it seems hardly likely in an arm's length situation that a licensor would waive or defer payment of royalties due to financial difficulties of the licensee. The licensor would usually be entitled to withdraw the right to use the relevant property.

In order to determine profits between integrated or associated companies, the so-called arm's length price is taken as basis; i.e. a price which would have been agreed upon by dependent business partners. This means that for purposes of taxation, the calculation of profits made by a corporation is based on the assumption that independent business partners are involved. In other words, economic interdependence plays no role in taxation. All agreements between associated companies which are not in line with this principle have to be offset by taxation. The income of the company deriving advantage from such an arrangement must be reduced and that of the company deriving disadvantage must be increased.

In applying the arm's length principle, tax authorities should, however, take into account the following points:

1. It should not be assumed that the prices actually charged within an MNE (multinational enterprise) will never be arm's length prices.
2. Transactions within an MNE may not be directly comparable with those which take place between independent enterprises.

The application of the arm's length principle to the prices charged within an MNE is based on the assumption that prices are determined on the markets in the different countries by ordinary market forces. However, there could be other factors that may modify the operation of the normal rules of a market economy. For example, a member of an MNE may, like any independent enterprise, sustain genuine losses whether from mismanagement, from unfavorable economic conditions, or from other circumstances like "start up" losses or "market penetration" losses which would, of their nature, be expected to be sustained only during a short period. Where, however, a multinational enterprise consistently makes losses over a period of several years in a particular industry, it might seem appropriate to regard the losses as artificial since an independent enterprise which consistently made losses would eventually go out of business.

Inter-company pricing

Since agreements between interrelated companies are reflected in most cases in inter-company prices, the examination and determination of inter-company prices for tax purposes stand in the foreground of the audit. There are a variety of ways of ascertaining arm's length prices. The 3 main broad methods used are:

a. **Comparable uncontrolled price method.** The inter-company price is determined in accordance with the prices reached between independent business partners of the same or a comparable business line.
b. **Resale price method.** Take the price at which the goods are sold by the connected purchaser (the reseller) to independent customers and then subtract a mark-up to arrive at the arm's length price for the sale by the original vendor.
c. **Cost plus method.** Take the vendor's cost and add an appropriate mark-up to arrive at the arm's length price for the sale by the original vendor and thus for the purchase by the reseller.

Since there are different ways of arriving at an arm's length price, a question arises whether it is possible to lay down any order of priority in using these methods. Clearly the comparable uncontrolled price method is basically preferable to other methods since it uses evidence most closely related to an arm's length price, but there may be cases where the evidence of resale profit mark-ups, production costs or other data may be more complete, more conclusive and more easily obtained than undisputable evidence of open market prices. There should always be the possibility, therefore, of selecting the method which provides the most cogent evidence in a particular case. It has to be recognized that an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek for a reasonable approximation to it. Frequently, it may be useful to take into account more than one method of reaching a satisfactory approximation to an arm's length price in the light of the evidence available.

In considering any one of the methods described, tax authorities need a substantial amount of reliable information about the activities of the MNE in different countries. Sometimes, fiscal authorities may lack certain information when examining intra-group sales. The tax authority assessing the buyer may have more information about transactions and conditions regarding market prices and mark-ups in its own country than in another and consequently may find it easier to rely on these data rather than trying to calculate the cost and profit markup of the related seller abroad. The country in which the original vendor is situated may have access to open market prices in the country and to the costs and profit ratios of the producer, but may be ignorant of the resale prices and mark-ups obtained by the foreign subsidiary. But it should always be possible for the taxpayer to introduce evidence from the other country. Equally tax authorities will find it useful to develop their own sources of such evidence. This is an area where there could be more frequent, and more effective, exchanges of information between tax administrations, it being understood that due regard should be paid to the requirements of business confidentiality. It is perhaps worth emphasizing too that the co-operative production of information by the enterprise and the MNE of which it is a member may be helpful in achieving a mutually satisfactory result both to the taxpayer and to the tax authorities.

Comparable uncontrolled price method

The comparable uncontrolled method offers the most direct way of determining an arm's length price. The transfer price is set by reference to comparable transactions between a buyer and a seller who are not associated enterprises. Uncontrolled sales may include sales by a member of an MNE to an unrelated party and sales to a member of an MNE by an unrelated party as well as sales in which the parties are not related to each other or to the MNE (though they may themselves be members of other MNEs). Uncontrolled sales are, in short, sales in which at least one party to the transaction is not a member of the taxpayer's affiliated group, but they would include only bona fide transactions and not sales unrepresentative of the market, for example, made in a limited quantity at unrealistic prices to an unrelated buyer, for the purpose of establishing an arm's length price on a larger transaction. The method requires the uncontrolled transactions to be carefully reviewed for comparability with controlled transactions. A number of factors can affect the price; these are discussed in the following paragraphs.

For the prices of goods to be comparable, it is necessary to look at prices of goods sold on markets which are economically comparable. The progressive liberalisation of international trade which has taken place during the last decades has certainly facilitated access to new markets, but it has not led, even in the countries where this liberalisation is the most extensive, to the constitution of one single market where transactions would be made always and everywhere under the same conditions. Only in very few cases is it possible to determine directly an arm's length price in one country on the basis of market prices in another country. Geographically different markets therefore can be satisfactorily compared only if the economic conditions are the same or differences in conditions can be easily eliminated. The variety of economic and social structures, of geographical situations and of consumers' habits means that supply and demand of the same product may vary considerably from one country to another. In practice, market prices do vary from one country to another or even within one country and in addition different country policies in many spheres (for example, value of currency, taxes, competition policy, price or exchange control, size and efficiency of market and degree of concentration) are likely to influence price levels. On the other hand, an enterprise enjoying monopoly or other dominant position in the market can, and often will, charge uniform prices to all its unrelated customers or to all of them in particular areas, or uniform prices modified only by identifiable market specific factors such as import duties. This situation may be found for example in the provision of certain goods or spare parts.

For prices to be readily comparable, it is, among other things, necessary to compare goods sold at the same point in the chain from producer to consumer or to be able to quantify easily the different points in the chain. To take perhaps the simplest example, there will be a difference between the wholesale and retail price of a commodity but if the retailer's mark-up is readily ascertainable, it should not be difficult to make the necessary adjustment.

Direct comparison of controlled sales with sales in an uncontrolled situation will be more readily acceptable if the goods concerned are as nearly as possible physically identical, but if the differences are important, a useful comparison may still be possible so long as appropriate adjustments can be reasonably made to the uncontrolled price to take account of the differences. Similarly, it may be possible to derive some help from sales of substitute goods though much will depend on the circumstances. It is likely to be easier to find comparable uncontrolled prices where the goods are natural products or mass manufactured goods in common production, but even so in many seemingly homogeneous products, such as steel, quality differences are an important determinant of price and this has to be taken into account. Nevertheless, in general it is fair to say that the less standardized the goods, the less easy it will be to find comparable uncontrolled prices. To find comparable open market prices for semi-finished goods or components may sometimes be extremely difficult and sometimes impossible, since to the extent that they are specialized they are less likely to be traded on the open market.

In comparing controlled sales with uncontrolled sales, the following factors also have to be considered: the volume of sales must be comparable (if the volume has an effect on price); the uncontrolled sales must be realized at a time reasonably close to the period during which the transactions under consideration were made, because market prices may vary over time due to seasonal fluctuations or to changes in the general economic situation; the terms of sale may also justify price variations; costs of transport, packaging, advertising, marketing, guaranteeing may or may not be included in the deal; the terms of payment are also relevant factors; foreseeable or expected fluctuations in exchange rates or in rates of inflation may be expected to have been taken into account (for example by invoicing in a hard currency or by indexing or by advance payments).

When intra-group sales are compared with uncontrolled sales it is necessary to consider whether the seller has rendered auxiliary services to the buyer and whether any intangible property such as patents, know-how, good will, or trademarks have also been transferred in connection with the sale of goods. It is characteristic of transactions within MNE that services or transfers of intangibles are frequently connected with a sale, and this is particularly true in some high-technology industries. In such cases, remuneration for the use of intangibles or for the rendering of services may form an element of the price of goods or may be separately invoiced.

Resale price method

The resale price method begins with the price at which a product which has been purchased from a related seller is resold to an independent purchaser. This price is then reduced by an appropriate mark-up representing the amount out of which the reseller would seek to cover his costs and make a profit. What is left after subtracting the mark-up can be regarded as an arm's length price of the original sale. This method is probably most useful where it is applied to marketing operations.

Appraising the appropriate mark-up presents difficulties. There would be least difficulty where the buyer and reseller do not add substantially to the value of the product (though even in such a case the matter may not be simple). It is therefore in cases where there is no usable evidence of comparable uncontrolled sales and where the associated seller contributes the greater part of the value of the goods, that this method is likely to be most useful. It will be less helpful where, before resale, the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed (for example, where components are joined together in finished or semi-finished goods) with the result that the contribution of the goods to the value of the final product cannot be simply distinguished. Whereas the comparable uncontrolled price method calls for the use of comparable prices, the resale price method calls in effect for the use of comparable mark-ups. But these are not easily found. The determination of the costs of the buyer and reseller should not cause too many problems, but deciding on the size of any profit which should be included in the mark-up may well provide cause for argument.

A resale price would be most useful as a starting point if realized within a short time before or after the time of the controlled sale. The more time that intervenes between the two, the more likely it is that other factors – changes in the market, in rates of exchange, in costs, etc. – will need to be taken into account in any comparison. Tax authorities have also to consider that where the value of the product is affected at the resale stage by the use of a trademark or other intangible property, the value of the product may be so changed as to make application of the resale price method difficult, if not impossible.

The profit mark-up can be expected to be related predominantly to the value of the functions performed and the risks taken by the person reselling the product. This can clearly range widely from the case where the reseller effectively performs minimal services as a forwarding agent to the case where he takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing or distributing and guaranteeing the goods, financing stocks and other connected services. If the reseller does no more than sell the goods on again, in circumstances where it is clear that he has had to make little or no effort, it would be reasonable to argue that his profit would be a small one. This would particularly be the case where he did not take delivery of the goods and he was operating in a low tax or no tax country in which his customers for the most part did not reside. But even in that situation it could be argued that his intervention merited more than a minimal profit if it could be shown that he had some special expertise in the marketing of such goods or bore, in effect, special risks. Such a claim in these circumstances would, however, need to be well supported if it were to be accepted. It would be more easily acceptable if the reseller was carrying on a general brokerage business – though this is unlikely to be a genuine situation in the context of associated enterprises – in which case, however, the profit mark-up could be related to a brokerage fee. On the other hand, where the reseller is clearly carrying on a substantial commercial activity involving such operations as the breaking of bulk, packaging, advertising, marketing, storage, transport, distribution and servicing of the goods and bears the related economic risks, then a reasonably substantial mark-up might be expected.

The profit mark-up may be expected to vary also with regard to whether or not the seller has the exclusive right to resell the goods. Arrangements of this kind are found in transactions between unrelated parties and may influence the price so that the use of the arm's length concept does not therefore require an exclusive right of this sort to be ignored. The value to be attributed to such an exclusive right will depend to some extent on its geographical scope and the existence and relative competitivity of possible substitute goods. The arrangement may be valuable to both vendor and reseller in the arm's length situation. It may stimulate the reseller to greater efforts to sell the vendor's particular line of goods, or on the other hand, in providing the reseller with a kind of monopoly, may have the result that he makes little effort to sell the goods. In consequence, the effect of this factor on the reseller's profit margin, though it may be important in some cases, will need to be examined with care.

The profit mark-up of a distributor associate may be estimated by reference to the profit mark-up which he earns on items purchased and sold in uncontrolled transactions. Failing that, the profit mark-up earned by a totally uncontrolled party may serve as a guide, though this should be applied only with considerable caution.

The cost plus method

This method of estimating an arm's length price is based on the supplier's cost to which an appropriate profit mark-up is added. It is a method that raises problems both as regards assessing cost and the appropriate mark-up for profit and is likely to be appropriate as a determining criterion mostly in specific situations, though it may also be useful as a means of verifying provisionally acceptable prices after other methods have been applied. Whilst it is true that an enterprise has to cover its costs over a period of time to remain in business, its costs do not usually help much in forming an opinion of the appropriate profit in specific cases.

The cost plus method may overemphasize historical costs, ignore demand, fail to reflect competitive conditions adequately, and it assumes a profit whereas, in real life, business profits are not always guaranteed. It is, moreover, difficult to allocate costs to particular products in a satisfactory manner. Also some costs may be abnormal (due to mismanagement, for example).

Nevertheless, the cost plus method may be helpful in estimating an arm's length price, when semi-finished products are sold between related parties or when different entities of an MNE concluded joint facility agreements or long-term buy-and-supply arrangements or when the subsidiary essentially performs a role of subcontractor. Also prices fixed on a cost plus basis are in fact a feature of some arm's length transactions particularly where the contract is for a specialized product tailored to suit the individual customer alone and the costs of product are heavy and unpredictable. Some Government contracts for the supply of military equipment and some turn-key factory projects provide examples of this.

It may be difficult to determine the relevant cost, because cost accounting concepts are not universal and vary from country to country and from business to business and this could provide scope for argument. Tax authorities will need to discover what costing methods have in fact been used. If these are suitable and appropriate and used consistently by the enterprise (as in calculating prices charged to independent third parties as well as in calculating prices charged to associated enterprises), tax authorities might reasonably find it satisfactory and convenient to use them. However, whatever the costing methods applied, the selling prices thus derived for intragroup transactions would have to recover not only the direct cost of purchasing raw materials, components and goods, the cost of salaries and other expenses of processing, but also relevant overhead or indirect costs (including normally a proper share of research and development costs) in order to make, under normal conditions, an appropriate profit on these transactions. Prima facie the costs to be attributed to individual units of production are the relevant historical costs but the costs of the input of materials and labor will vary over a period and it may often be necessary to accept some averaging of the costs incurred over a period of time, over a group of products, or over a particular line of production. The allocation of the cost of fixed assets will also present a problem and, particularly where the production or processing of different products is carried on simultaneously and the value of activity fluctuates. Again some reasonable averaging will need to be accepted.

The costs which can be considered are limited to those of the vendor, and this may raise the problem of how to allocate some costs between vendors and purchasers. For this it is necessary to consider the functions performed and the risks undertaken by the parties to the transaction.

Also to be taken into consideration is the way in which exceptionally heavy costs such as expenditure on capital equipment, research projects and advertising campaigns should be attributed to the different units involved. A related program is how overhead costs should be apportioned; whether, for example, they should be apportioned by reference to turnover or to number or cost of employees or to some other criterion. A manufacturer faced with the contention of a tax authority that revenue from associates should be uplifted on a cost plus basis may argue that certain of his sales into foreign markets represent a disposal of marginal production so that he need only take variable or incremental costs into account. Such a claim could only be justified if it could be shown that the goods could not be sold at a higher price. No general rule can be set out which will deal with all cases and the various methods used should be consistent as between controlled and uncontrolled sales and should also be consistent over time in relation to particular enterprises.

In addition to identifying appropriate costs, there is the problem of determining an appropriate profit mark-up. Ideally the seller's mark-up should be determined by reference to the seller's mark-up on similar items purchased and sold in uncontrolled transactions. If the seller makes no uncontrolled sales, its gross profit will have to be estimated from that earned by uncontrolled sellers performing similar activites. Here again, as in applying the resale price method, it is important to analyse the actual economic functions of the associated enterprise.

The methods described above do not by any means exhaust the possible techniques, and it does not follow that if an approach has not been mentioned, it ought not to be followed. The preceding analysis should, however, help to indicate how tax authorities and multinational enterprises may come in an informed way to the discussion of whether, and if so what, adjustments are appropriate to the transfer prices involved in the transactions in which they are interested in the context of sales of goods.

Transfer of funds across international boundaries

One practice of MNCs worth mentioning under this topic is the dollar-peso swap transaction. Under this scheme, a non-resident foreign corporation with the approval of the Central Bank, deposits foreign currency with a local branch of a foreign bank under a 343 account on condition that the bank lends local currency (pesos) to a local subsidiary to be used as operating capital or expenses of the latter.

Tax benefits under this scheme are: (a) the foreign corporation gets a direct benefit in the form of tax exempt interest on its foreign currency deposit under R A 6426, as implemented by Central Bank Circular No. 343, and (b) indirect tax benefit in the form of a deduction from interest taken by its subsidiary on the peso loans.

Allocation of overhead expenses

As explained earlier, resident foreign corporations (branches of foreign corporations in the Philippines) are taxed on their net taxable income from Philippine sources at the rates of 25% on the first ₱100,000 and 35% on an amount in excess of ₱100,000. Under Sec. 37(b) of the Tax Code, a resident foreign corporation may deduct from its gross income from the Philippines, expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, and other deductions which cannot be allocated to some item or class of gross income. And Section 160 of Revenue Regulations No. 2 (or Income Tax Regulations) explaining in detail how the "other deductions which cannot definitely be allocated to some item or class of gross income" are to be apportioned, prescribes:

> Sec. 160. *Apportionment of deductions.* From the items specified in Section 37 (a) as being derived specifically from sources within the Philippines there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses or deductions which can not be definitely allocated to some item or class of gross income. The remainder shall be included in full as net income from sources within the Philippines. The ratable part is based upon the ratio of gross income from sources within the Philippines to the total gross income.

Expressed in a formula (usually referred to as the "Massachusetts Formula"), the amount of deductible expense against Philippine income is arrived at as follows:

$$\frac{\text{Philippine gross income}}{\text{World gross income}} \times \text{World expenses} = \text{Philippine deductible expense}$$

The problem with the above equation is that there are two unknown factors: the world income and world expenses. The problem arises because of the difficulty in identifying, quantifying, and allocating certain expenses. It is difficult to identify those head office expenses, particularly if they are fixed, which are incurred solely on behalf of the branch, those incurred for the branch as well as other parts of the enterprise, and those that have no relationship to the branch's activities. Verifying the amount of directly related and indirectly related expenses is time-consuming. Finally, numerous allocation formulas exist by which indirect expenses may be reasonably apportioned, each formula leading to a substantially different result. These problems are compounded when the nonresident refuses or is unable to make the original books of account available to the developing country's tax administration.

Philippine experience on this matter is rather discouraging. In the leading case of Ginn & Co. vs. CIR, CTA Case #674, it was ruled that "expenditures made by a foreign corporation in conducting its business are deductible in computing its taxable income from sources within the Philippines only when allocable to the production of income from sources within the Philippines or where a ratable part of general expenditures is apportioned to income from sources within the Philippines. The contention of respondent (CIR) that the deduction of a proportionate home office expense of petitioner cannot be allowed as a deduction because "in the very nature of things, it is impossible to check and verify said expenses' is without merit. The fact that it is difficult for respondent to check and verify the alleged expenses because the records concerning the same are kept in a foreign country is no justification for the denial of the deduction, otherwise the law would be rendered meaningless. It is, however, essential that there be proof that a portion of such home office expenses is allocable to income from sources within the Philippines."

Remittance of profits by way of royalties, license fees, etc.

Royalty payments to non-resident foreign corporations are subject to 35% withholding-tax-at-source. If the royalties, however, are to be paid to corporations of foreign countries with which the Philippines has tax treaty agreements, we have agreed in industrial royalty cases that the rates of withholding tax to be charged shall not exceed (a) 15% of the gross amount of royalties where the royalties are paid by an enterprise registered with the Board of Investments and engaged in preferred areas of activities in the Philippines, and (b) 25% of the gross amount of royalties, in all other cases. This is necessary in order to reduce as much as possible the cost of taking advantage of modern processes abroad and eventually hasten the economic development of the country.

While admittedly multinationals are very ample sources of transfer of technology for the developing countries, the latter are charged heavily for such transfers in the form of royalty and licensing fees. Philippine experience shows that royalties due or remitted to parent companies abroad are, more often than not, bigger than the declared profits. Aside from draining our foreign exchange reserves, this practice of charging royalties deprives our country of its just share from the revenues earned by the subsidiaries. To minimize this loss, the Central Bank of the Philippines issued Circular No. 393 limiting the royalty payable by licensees of patents, copyrights or trademarks to 2% of gross sales for products of licensors manufactured in the Philippines and 3% of gross sales for technical service fees.

Aside from royalties, licensing agreements for the use of certain technology executed between the parent company and the subsidiary always provide for payment of technical service fees by the latter. These fees are supposed to cover expenses incurred by the parent company for research and development on marketing, sales, and further development of the products covered by the license. The expense is charged to the subsidiary through debit memos in lump sums. No details of the expenses are given except the statement that the subsidiary is being charged such expenses which represent its allocable share. In addition to the problem of substantiation pertinent to such deductible expense, our tax agency is beset by the problem of situs with respect to the taxability of such technical service fees. The head office usually alleges that the services were rendered outside the Philippines and consequently, the income therefrom is not subject to Philippine income tax.

The term "royalty" used to cover only amounts paid for the use in the Philippines of intangible personal property rights, such as copyrights, patents, secret formulae or processes. The concept of royalty, however, was broadened and enlarged by PD 1457 which took effect on June 11, 1978. Now, royalty includes also the supply of technical, scientific or other information, assistance, service or advice which is ancillary or subsidiary to the use of property or installations or operation of any equipment, machinery or other apparatus. As a result of this change in concept, we hardly encounter problems on this.

Multinational shipping companies

Up to 1972, our Tax Code imposed upon international carriers, both shipping and airlines, on their net income from sources earned within the Philippines, the corporate income tax rates of 25% on the first ₱100,000 and 35% on the excess over such amount.

The taxable base of an international carrier was arrived at by subtracting from its Philippine gross income an aliquot part of its worldwide expenses determined on the basis of the "Massachusetts Formula" of allocation. Thus our pertinent Income Tax Regulation provides:

> Sec. 163. *Foreign steamship companies.* The returns of foreign steamship companies whose vessels touch ports of the Philippines should include as gross income, the total receipts of all out-going business whether freight or passengers. With the gross income thus ascertained, the ratio existing between it and the gross income from all ports, both within and without the Philippines of all vessels, whether touching ports of the Philippines or not, should be determined as the basis upon which allowable deductions may be computed, the principle being that allowable deductions shall be computed upon a basis which recognizes that the income arising and accruing from business done if any from this country shall bear its share and no more, of expense, incident to the earning or creation of such income, in the ratio that the gross income arising in and from this country bears to the entire gross income arising from business done both within and without this country. In other words, the net income of a foreign steamship company doing business in or from this country is ascertained for the purpose of the income tax, by deducting from the gross receipt from outgoing business such a portion of the aggregate expenses, losses, etc., as such receipts bear to the aggregate receipts from all ports of all vessels, including in each case income of a nonshipping character but incidental, to the shipping business such as dividends from investments, interest on deposits, etc. . . .

In the enforcement of this system of net income taxation, we encountered the following difficulties:

1. In the case of tramp vessels (which handle a substantial portion of our exports) tax collection was minimal. Not plying a regular route and entering our ports only once a year, they are difficult to supervise.
2. Considering the peculiarities of international transportation business that these shipping and airline companies are engaged in, accurate allocation of particular income to each port is difficult.
3. Because they are foreign-based, the main data to determine net income is located in their offices abroad. Thus, we are forced to rely on submitted audited financial statements for lack of authority to verify facts beyond our national boundary.
4. There exists a lack of uniformity in the income tax laws of the various countries where they engage in business, requiring the presentation of separate statements by each foreign corporation which gives rise to difficulties both on the part of the government and taxpayers. Again, we are unable to determine what is being reported to a different taxing authority.

Most of the Philippine income tax returns being filed by these international carriers showed "net losses." When our examiners were allowed to audit their books of accounts abroad, (1) they found out that these carriers were also engaged in business lines which were non-transport in nature, like hotels, supermarkets, and pilot training. We found out that in all those years, we were allowing non-deductible expenses to be partly charged against Philippine income. It was also revealed that (2) establishment of routes of airline and shipping companies is not normally dictated by business reasons but by political decisions. Why should Philippine income be burdened with such deductions and losses which the Philippines has nothing to do with?

Cognizant of the attendant administrative difficulties in the enforcement of net income taxation of international shipping and airline companies, we shifted to the gross income approach. Our opportunity to do so came with the advent of martial law, when, on November 24, 1972 Presidential Decree No. 69 was issued. This decree, among others, provides that . . . international carriers shall pay a tax of 2½% on their gross Philippine billings . . .

The rationale for this shift in the tax base is explained by our Minister of Finance, the Honorable Cesar Virata, in his keynote speech, to wit:

> In the case of shipping and airlines, we did another thing. We used to subscribe to what is known as the Massachusetts formula of trying to allocate on a world-wide basis of what is the income derived from the Philippines and the related cost in order to determine what income tax should be paid to the Philippines. In our recent reform we thought that we should simplify this particular matter because my personal view is that, in many instances, our examiners cannot really go into all of these computerants abroad. Imagine, examining Pan American, you know what they spend throughout the world and what they earned throughout the world. Trying to determine whether they are appropriate income or charges is extremely difficult before you could sensibly say what is Philippine income and what is Philippine expense. *We went on the theory that there is a presumed income. They would not operate in the Philippines if they are losing money. So we tax on a gross basis of 2½% of their gross billing; assuming that there is a margin of 10% that is the income and using the first rate of tax, the 25%, then we charge them 2½% for whatever gross billings they derive from the Philippines. . .* (italics supplied)

To forestall divergent interpretations among international carriers, "Gross Philippine billings" is defined as follows:

"Gross Philippine billings" includes gross revenue realized from uplifts anywhere in the world by any international carrier doing business in the Philippines of passage documents sold therein, whether for passenger, excess baggage or mail, provided the cargo or mail originates from the Philippines. The gross revenue realized from the said cargo or mail shall include the gross freight charge up to final destination. Gross revenues from chartered flights originating from the Philippines shall likewise form part of "gross Philippine billings" regardless of the place of sale or payments of the passage documents. For purposes of determining the taxability of revenues from chartered flights the term "originating from the Philippines" shall include the flight of passengers who stay in the Philippines for more than forty eight (48) hours prior to embarkation. (Sec. 24(b)(2) of the National Internal Revenue Code)

In aid of this basic reform in our tax system, more particularly for the efficient collection of taxes due on the operations in the Philippines by tramp vessels, an appropriate circular was issued (Revenue Memorandum Order No. 21-78). Tramp vessels are allowed to depart for their destinations abroad, only after a proof of payment of internal revenue taxes has been presented or a voyage bond equal to 150% of the taxes due has been filed with the Bureau of Internal Revenue. A sixty-day period from the date of departure of the tramp vessels within which to pay the internal revenue taxes covered by the voyage bond is allowed. The income tax due bears interest at 20% per annum from the date of departure until the date of payment. Upon payment of the internal revenue taxes due from a voyage undertaken by a tramp vessel, the voyage bond is cancelled and the principal and surety notified accordingly of its cancellation.

Effects of the gross billings tax

The abandonment of the net income approach and the corresponding shift to the gross billings tax resulted in the following:

1. Now the criterion used for international airlines is an uplift of passage tickets sold in the Philippines. Under this criterion, for foreign international carriers to become subject to Philippine income tax 3 requisites must concur, namely:
   (1) The foreign international carrier must be doing business in the Philippines;
   (2) The passage ticket must have been sold in the Philippines; and
   (3) There must be actual uplift anywhere in the world for the ticket sold in the Philippines, except that for cargo or mail, the uplift must have originated from the Philippines and in this case, should include freight charges up to final destination.
2. There was a dramatic increase in income tax collection. For example, a comparative study was made on 12 major on-line international airline companies regarding their income taxes paid, based on income tax returns filed before and after the imposition of this across the board 2½% tax on gross billings. The percentage of increase was a whopping 482%. The following year it rose to 832%.
3. Certain administrative difficulties were minimized, if not eliminated, such as those involved in:
   (a) ascertaining the net income from Philippine sources;
   (b) allocating income and deductions among the different countries involved;
   (c) and checking books of accounts which are usually kept in the respective home countries of the foreign corporations.
4. Tax collection from tramp vessels has been prompt and immediate because their accounting (taxable) period has been shortened for each and every voyage undertaken in the Philippines.
5. Off-line international airlines (i.e., those having no flight operations to and from the Philippines) are now considered "doing business in the Philippines" if either by themselves or through their agents, they sell passage tickets in the Philippines. Their general sales agents (GSA) or duly authorized representatives in the Philippines are constituted as withholding agents. (Revenue Regulations No. 3-76 dated March 15, 1976)

Thus, the business activities of off-line airline companies are now placed on equal footing with on-line airlines for income tax purposes.

6. Before this innovative gross billings tax, revenue realized by international carriers out of chartered flights to and from the Philippines is not subject to Philippine income tax because the passage documents are generally sold outside the Philippines. With charter fares being much lower than the fares collected by scheduled flights, our adoption of the open skies policy in international airline operations resulted in the tremendous increase of the number of chartered flights and volume of traffic, to the disadvantage of scheduled flights. By taxing revenues from chartered flights originating from the Philippines regardless of the place of sale or payments of the passage documents, healthy competition between chartered and scheduled operations is promoted, and at the same time generates government revenues from the former, which are equally benefited by our open skies policy.

CONTROL OF MNC AND EXCHANGE OF INFORMATION

Control of MNC

The alternatives for control of the multinational enterprise are the following: (1) unilateral action, either by the host country or the home state; (2) bilateral action, by two host countries or by the host country and the home state; and (3) multilateral action, on a universal or semi-universal basis (which would include the host as well as the home country) or on a regional basis or groups of countries. It is also possible to combine these various alternatives.

The first difficulty in every type of control is that the legal framework applicable to the multinational enterprises has not yet been sufficiently refined, either at the level of national law or that of international law. At the present state of development of this framework, only the multinational enterprise formed in pursuance of a treaty or other type of intergovernmental agreement may be so called. However, this is not the kind of public enterprise most in need of control, at least not as a rule. As D.F. Vagts observes, the "law of the multinational enterprise" has serious deficiencies. In the first place, it is divided into categories dealing with different aspects separately and does not view the phenomenon as a whole; in the second place, it is basically obsolete, inspired by an outdated situation; third, the forms and actions of the corporation are so a typical that they preclude the establishment of stable precedents which are regular and similar enough to become the basis of the necessary juridical norms; and finally, one cannot think about legal control without also dealing with the underlying economic problems, which have not yet been clearly understood.

In spite of these difficulties, systems of control on the unilateral level have gradually emerged involving both host and home governments. A first requisite for the effectiveness of this system is adequate information on the multinational enterprise to be controlled, its mode of action and its strategies – a requisite that, although obvious, may be most difficult to impose. This assumes, of course, that there also exists the professional capacity to obtain and to process the information and to formulate the corresponding conclusions, a capacity that may not be available to many developing nations. Significant tests of this capacity have been made by introducing the "obligation to inform" in Canada and the European Economic Community.

Methods of control by the host country

The most important weapon at the disposal of every state is the power to accept or reject the intrusion of a multinational enterprise in its economy. However, as well as being the most important, it is the most difficult to manage for various reasons. The first of these is that a developing country faces a conflict of interests: the fear of associating itself with a powerful entity and the necessity to encourage investments and technology for its development. This situation is precisely the one which the multinational enterprise knows how to exploit through its enormous capacity for negotiations. Another reason is based on the application of legislation relating to foreign investments which is not yet sophisticated enough to distinguish efficiently between traditional foreign investment and the investment of the multinational enterprises, which often have a radically different effect.

This leads to the conclusion that the efficiency of the system of control adopted by the host country will depend basically on two factors. The first is the development of its own capacity to negotiate deals which are not disadvantageous to itself. The second factor is the refining of the legislation on foreign investments and of the procedures of registration and selection and, above all, the abrogation of restrictive trade practices through efficient regulations.

Closely related to these policies are proposals for further measures to be initiated by the host country, such as creating competing corporations within the host country itself, developing a policy for building up the national private sector, entering into joint ventures and drawing up effective accords on licensing management.

Apart from the problems examined, the major weakness of unilateral control by the host country is the fact that the multinational enterprise, by its structure, will normally be able to evade many aspects of the controls because its operations extend beyond the frontiers of the host state in question. Two possible remedies for this situation are: either an extremely efficient form of national control, which to this day does not exist, or control by more than one country, i.e. control which ceases to be unilateral.

For the same reasons we must dismiss the favorite alternative of the multinational enterprises themselves; the code of "good conduct", of "rights and obligations" of the multinational enterprise or of "good corporate behavior" – a proposal based on the idea of self-imposed discipline by the corporations and of directives that they will voluntarily undertake to respect. If the developing countries have any experience at all in this matter of international economic relations, the most frustrating is that good intentions are no guarantee at all of their rights and interests.

Methods of control by the home country

The country in which the multinational enterprise has its principal base, which in 19% of the cases will be the United States, also faces the possibility, and in many cases the necessity, of controlling such companies. We are not interested in the controls that the home country exercises over the activities of the company within its own borders, for this is an internal problem. What we are concerned with are the controls applicable to the company's activities abroad, whether directly or through its subsidiaries. The extraterritorial application of national legislation causes acute conflicts of sovereignty, but it also could mean a type of unilateral action that would lead to saner commercial practices.

It is perhaps in this field that the obsolescence of the classic law is best in evidence, especially when the question is to determine the nationality of the company to be controlled. Frequently, the subsidiary operating abroad will have a different nationality from that of the parent company. For certain purposes, such as the confiscation of enemy property in times of war, the nationality of the corporation is determined by that of its owners or controllers, but this has not been the rule for multinational enterprises. This illustrates well the necessity of adopting clear norms for particular cases and the necessity of focusing on the phenomenon as a whole.

Regional co-operation

Developing countries have a great deal to gain from measures of regional co-operation among themselves. Such measures would also greatly assist them in their dealings with multinational corporations.

Regional co-operation not only strengthens the bargaining position of developing countries but also helps them to evolve an appropriate technique for dealing with the problems which are caused by the activities of multinational corporations; the inducement to invest is enhanced. In order to gain access to large regional markets, multinational corporations have been willing to accept terms and conditions which they would reject from small countries. Developing countries in such conditions not only secure the co-operation of the corporations on better terms but also benefit from the economics of scale. A number of developing countries have attempted to achieve these purposes by regional co-operation of various forms and degrees of comprehensiveness, although progress has been uneven on the whole. Hence, developing countries should intensify their efforts for regional co-operation, in particular the establishment of joint policies with regard to multinational corporations.

Exchange of information

The main trading partners of the Philippines have been the United States, Japan, and the Federal Republic of Germany, in that order. To date, we have concluded 9 tax treaties, including that with Japan. Pending ratification is the tax treaty with the United States and under negotiation is the tax treaty with West Germany. In all the tax treaties that we have so far concluded and are pending negotiation, we always include a provision on exchange of information. Since the Philippines is relatively new in the business of negotiating tax treaties, we still have no problem on exchange of information.

While inter-government efforts towards exchange of information in the form of bilateral tax treaties is pursued, the Philippines at the same time takes active participation in regional cooperation, such as the SGATAR. After all, it has been said that the most effective recourse is cooperation and coordination among national tax administrators. Accentuating the need for inter-country cooperative action, an author described its advantages:

> With intergovernmental cooperation on tax matters, information can be found at the easiest place to find it, without the taxing country's administrators moving away from their desks. . . . . The less affluent governments which cannot afford to train their own revenue officers can band together with others in a common training program for the common good. Each country can benefit from the accumulated fiscal experiences of the others, and taxpayers can be frightened away from foreign evasion schemes by being told that the governments are combining forces against the international tax evader.

Conclusion

Obviously, MNCs have the upper hand in the sense that while they operate in many places of the world, we tax administrators can enforce tax laws only within the boundaries of our respective States. It has become necessary, therefore, that we even up matters by seriously pursuing the exchange of information not only by way of tax conventions but through other simpler avenues. This is significant inasmuch as a tax treaty is not easily concluded between countries.

In the Asia and Pacific Region, SGATAR and similar conferences, more definite agreements and instruments towards having exchanges of information on tax administration should be vigorously pursued. The lack of existing tax treaties among Asian countries necessitates the establishment of other viable channels towards tax coordination.

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OCTOBER 1983

British Branch I.F.A.: U.S./U.K. Seminar. London (United Kingdom), October 6-7 (English).

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NOVEMBER 1983

Management Centre Europe: Leasing (including: tax aspects). Brussels (Belgium), November 3-4 (English).

Management Centre Europe: International finance (including: tax implications of financing and foreign exchange transactions). Nice (France), November 7-9 (English).

DECEMBER 1983

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SEPTEMBER 1984

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). September 16-21 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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).

BOTSWANA:

Budget 1983

Extracts from the Budget Speech pronounced by Mr. P.S. Mmusi, Vice-President and Minister of finance and development Planning, on 21 February 1983

See for detailed information on Botswana taxation the International Bureau of Fiscal Documentation's publication: AFRICAN TAX SYSTEMS.

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FINANCIAL LEGISLATION

115. Mr. Speaker, the continuing process of the review and reform of the tax system was taken a step further during the current fiscal year. The tax base was broadened and diversified by the introduction of a selective sales tax and the inclusion in the income tax base of gains made on the disposal of business assets.

116. Mr. Speaker, I propose to abolish the Death Duties Act with effect from 1st July, 1982. Honourable Members on this House are aware of the reasons why these taxes which have been on our statute book for several years are no longer acceptable. In keeping with my general approach to tax reform, favouring broadening of the tax base on the grounds of equity and revenue yield, I now propose to introduce a capital transfer tax, to be imposed through the Income Tax Act, on recipients of inheritances, legacies and gifts. The rates of tax will range from 3% on the first P30,000 of taxable transfer value, rising by steps of 1% to 7% on taxable transfer value in excess of P380,000. I consider these rates to be reasonable and I shall provide for generous tax thresholds which will be deductible from the value of property transferred before tax becomes chargeable. The basic principle underlying this proposal is that tax is to be imposed on transfers of property from one generation to the next. Tax will therefore not be imposed on property transactions between spouses, including legacies or inheritances. In keeping with the general trend of this policy, I shall also provide that a married woman in receipt of taxable transfer value will be subject to tax in her own right so that her taxable transfer value will not be aggregated with that of her husband. Mr. Speaker, I shall provide that when this proposal passes into law, the tax shall come into force as from today, so that no opportunity is given to anyone to avoid it between now and the date of Assent. This is a normal precautionary measure adopted with regard to taxes on individual transactions.

117. Mr. Speaker, I propose to alleviate the burden of the tax on capital gains by increasing the pre-1982 capital accretion factor from 5% per annum on cost to 10% per annum compound. This change will result in a substantial relief to all persons who derive capital gains on property acquired before 1982. With regard to gains made on property acquired after 1982, I am of the view that the limitation of the taxable gain to 50% of the actual gain made provides adequate relief. I shall also extend the period of off-setting of capital losses to a reasonable period, considered necessary to accommodate cases where genuine losses occur.

118. The Presidential Commission on Economic Opportunities has recommended broadening the tax rate bands at the upper income brackets, on the grounds that the present rates act as an obstacle to the recruitment of expertise at upper and middle management levels. I am of the view, however, that this approach should also adequately cover corresponding grades in the public service, whose taxable incomes tend to be at a somewhat lower level. I also wish to extend some relief to the lower income groups, especially to those immediately above the taxable threshold. Persons in this income group, like all other tax payers, pay Local Government Tax at the maximum rate and the combined effect is regressive at this level.

119. The taxation of housing benefits has been a troublesome question for some years. My Ministry has had a dialogue with the private sector and as a result I have decided to scale down the computation of housing benefit by equating private sector housing with Botswana Housing Corporation rentals. The result will be that housing benefits which work out at an average of 10% of rateable values will be reduced to 6% of rateable value in the case of houses on the rating roll. In the case of houses which are not on the rating roll, the housing benefit will be 5% of current capital cost. This proposal will provide a significant benefit to the private sector.

120. The net result of these tax adjustments will be a reduction in revenue of some P3.1 m in the 1983-84 tax year. This is as far as the Government can go in accommodating the legitimate concerns that have been expressed over the tax burden on employers in these difficult times. I am confident that the loss in revenue will be more than offset by the incentive for higher productivity and increased employment, as these reductions translate into lower costs and greater economic activity in the long run.

121. Mr. Speaker, in view of the advance payments system operating in respect of designated companies, I do not propose to raise the company rate at this stage. Raising the company rate now may cause serious cash flow problems to these designated companies. Besides, it may jeopardise the success of the financial Assistance Policy, on which Government places great emphasis, both as regards economic opportunities in the field of investment, and in the generation of productive employment.

122. Mr. Speaker, the income taxation of livestock is affected by the very low standard values now operating. These will be revised upward for individual farmers, and farming companies will be required to adopt market values. The present standard values, combined with the rules for computing chargeable income, often result in artificial losses for tax purposes, so that farmers with sizeable incomes pay little or no tax. Further, the incentives encourage farmers to retain cattle on the land, rather than to increase their off-take. The closer standard values are to market values, the more evenly spread will be farming profits, so that, under normal circumstances, the tax paid by a farmer from one year to the next will be more or less the same and the incentive to overstocking is removed. Where there is exceptional offtake, the averaging provision is likely to reduce the tax. Since this tax is assessed after the end of the tax year, there will be no effect felt on tax revenues in 1983-84; the first impact will be in 1984-85.

123. Mr. Speaker, I also propose to impose restrictions on the deduction for tax purposes of management and consultancy fees paid to non-residents by resident companies. There is at present a great danger of tax avoidance through artifical or fictitious payments in this respect. The proposal leaves adequate scope for such payments to be made for genuine purposes.

124. Mr. Speaker, that concludes my address on the budget for 1983-84. I would welcome comments by the Honourable Members on my proposals, and on the policies I have outlined as appropriate under these circumstances. I therefore move that the Appropriation (1983-84) Bill be read for a second time.

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. See also Erratum (p. 193 of the May 1983 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Francesco Forte, Minister der Finanzen:*
Die Steuerpolitik der Republik Italien ... 393
Der Finanzminister erläutert eine Reihe von Aspekten der Steuerpolitik, die von der italienischen Regierung durchgeführt wird. Einer der wichtigsten Punkte stellt dabei die Bekämpfung der Steuervermeidung und Steuerhinterziehung dar; dies muss vor dem schwierigen Hintergrund eines hohen Haushaltsdefizits und einer hohen Inflationsrate gesehen werden. Der Minister befürwortet eine rationale und pragmatische Lösung, durch die eine gerechtere Verteilung der Steuerlast und eine Senkung der Inflationsrate erreicht werden sollen.

Antonio Lovisolo:
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Guglielmo Maisto:
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Der Verfasser untersucht die derzeit gültigen Bestimmungen in Italien, die die Verrechnungspreise betreffen. Diese Untersuchung beleuchtet insbesondere Art. 75 des Erlasses vom September 1973; dies ist die wichtigste Vorschrift für diesen Sachverhalt.

Gian Carlo Croxatto:
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Der Verfasser untersucht die Merkmale des Systems der Anrechnung ausländischer Steuern, das auf in Italien ansässige Personen anzuwenden ist, die ausländische Einkünfte erzielen. Die Möglichkeit der Steueranrechnung bleibt Nichtansässigen, die in Italien lediglich eine Betriebstätte haben, verschlossen.

Siegfried Mayr:
Besteuerung der Gewinne aus der Veräusserung von Vermögen – Die Behandlung Nichtansässiger im Falle der Veräusserung von Anteilen an italienischen Körperschaften 417
Der Verfasser beschäftigt sich mit der neuen Gesetzgebung, wozu es einige Streitpunkte gibt. Nach seiner Meinung sind Nichtansässige grundsätzlich immer zur italienischen Einkommensteuer heranzuziehen, wenn diese Gewinne aus der Veräusserung von Anteilen an einer italienischen Körperschaft erzielen. Allerdings können Doppelbesteuerungsabkommen eine Befreiung von der italienischen Steuer bewirken.

Augusto Fantozzi:
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Dieser Artikel untersucht die steuerliche Behandlung von Dividenden und Zinsen, die von in Italien ansässigen oder nicht-ansässigen Personen an in Italien ansässige oder nicht-ansässige Personen gezahlt werden. Besondere Aufmerksamkeit widmet der Verfasser dem neuen italienischen Anrechnungsverfahren; er weist darauf hin, dass das italienische System im Falle der Ausschüttung steuerbefreiter Dividenden keine "Ausgleichssteuer" erhebt.

Gianni Marongiu:
Steuerpotential and Steueraufkommen in Italien – Der Verfassungsartikel 53 im Lichte der Rechtsprechung des Verfassungsgerichts 426
Der Verfasser analysiert den Artikel 53 der italienischen Verfassung, der unter anderem bestimmt, dass alle Personen nach ihrer Leistungsfähigkeit besteuert werden sollen. Dieser Artikel ist auch deshalb interessant, weil er für die Legislative die Grenzen der Besteuerung festlegt.

Furio Bosello:
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Das Bankgeheimnis gegenüber den Steuerbehörden besteht nach wie vor in Italien. Durch die Steuerreform 1982 erhielten die Steuerbehörden jedoch erweiterte Möglichkeiten, Informationen von Banken zu erhalten.

Adriano di Pietro:
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Eusebio González:
Steuervermeidung, Missbrauch des Steuerrechts und Steuerhinterziehung in Spanien (mit Zusammenfassung in englischer Sprache) 441
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Nathan Boidman:
Steuerhinterziehung – Der gegenwärtige Grad der Steuerverweigerung 451
Dieser Artikel beschäftigt sich mit den Ursachen und dem Grad der Steuerverweigerung in bezug auf die Einkommensteuer; er basiert auf Erfahrungen in 17 Staaten (ausser den USA) und stellt die Gegenmassnahmen der jeweiligen Regierungen vor.

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* Monsieur le Professeur Forte est Ministre de la coordination des politiques des Communautés Européennes dans le Gouvernement nouvellement formé.

Official Inauguration of the Asian-Pacific Tax and Investment Research Centre

On 19 July 1983 the Asian-Pacific Tax and Investment Research Centre in Singapore was inaugurated by Prof. J. van Hoorn Jr., chairman of the Board of Governors, in the presence of authorities from different countries and of the many participants at the First Asian-Pacific Tax Conference held on 19 and 20 July. The opening ceremony was followed by a reception.

On the occasion of this event, which constitutes a significant development for the entire region, several messages had been received from, inter alia, the President of Sri Lanka, *J.R. Jayewardene;* the Prime Minister of the Philippines, *Cesar E.A. Virata;* the Minister of Finance of Singapore, *Hon Sui Sen;* the Minister of Finance of the Solomon Islands, *Bartholomew Ulufa'alu;* the Permanent Secretaries of Finance of Pakistan, *H.U. Beg* and Thailand, Dr. *Panas Simasathien;* the Commissioner of Inland Revenue of Hong Kong, *V.A. Ladd;* together with a message from the Executive Secretary of ESCAP, *S.M.A.S. Kibria,* which was read during the reception by Dr. *V.J. Ram,* Director or Manager, ESCAP/UNIDO Division of Industry, Human Settlements and Technology.

The 2-day conference held on this occasion was devoted to a subject of current interest: *Tax Planning – Tax Avoidance – Tax Evasion* and was attended by people from 17 countries. The speakers were:

S. Ambalavaner, Sri Lanka – Chief Executive of the Centre
Graham R. Clarke, Singapore – Senior Tax Principal Ernst & Whinney
Alun G. Davies, C.B.E., U.K. – Governor
Dr. M.P. Dominic, Singapore – Attorney-at-Law (Sri Lanka) and Advocate and Solicitor (Singapore)
J. van Hoorn Jr., Netherlands – Chief Executive, International Bureau of Fiscal Documentation and Chairman of the Centre
Ian Langford-Brown, FCA, Australia – Tax Consultant and Partner Deloitte Haskins & Sells
Lee Beng Fye, Malaysia – Executive Director Price Waterhouse Services
Raymond E. Moore, Hong Kong – Solicitor and Executive Director of Jardine Matheson & Co.
N.M. Qureshi, Philippines – Executive Director Asian Development Bank
Sidney C. Rolt, Singapore – Financial Consultant
O.P. Vaish, India – Advocate
Angel Q. Yoingco, Philippines – Executive Director National Tax Research Center
Khaja Habibullah, Pakistan – Chief Income Tax, CBR
Saiful Hamid, Indonesia – Deputy Director for Direct Taxes

During the conference, the first issue of the *Asian-Pacific Tax and Investment Bulletin* was handed out, as well as a book on Taxation in the Asian-Pacific Region prepared by *Jap Kim Siong,* Principal Research Assistant, International Bureau of Fiscal Documentation, Amsterdam.

Prior to the conference a 1-day seminar, co-sponsored by the Centre and the National Tax Research Center, was held in Manila under the title "New Thrusts in Tax and Investment Policies". Speakers were Prof. J. van Hoorn; Hon. Edgardo L. Tordesillas, Deputy-Minister of Trade and Industry; and Hon. Romulo Villa, Deputy Commissioner of the Bureau of Internal Revenue.

On 22 July, the Malaysian Chapter of the International

Details about the Centre and its library and other services are available from the Centre's headquarters at 2, Nassim Road, Singapore 1025. Telephone 235-1959. Telex RS 50257 APTIRC.

Fiscal Association and the Centre co-sponsored a seminar in Kuala Lumpur on "Taxation of Business Income of Transnationals with particular emphasis on Malaysian Tax Treaties" with Prof. J. van Hoorn, Mr. Lee Beng Fye and Mr. Ahmad Khan, deputy chief executive of the Centre, as speakers.

A seminar scheduled later on in Colombo by the Centre had to be cancelled because of the difficult situation in Sri Lanka.

OECD Activities in the Field of Taxation

The OECD Committee on Fiscal Affairs has continued to act as a forum where tax authorities of OECD member countries can meet regularly and exchange views on current policy issues. It also lays down the work programmes of its Working Parties and follows their execution. The main activities of the Commitee over the last period have been the following.

INTERNATIONAL CO-OPERATION

As part of its mandate to proceed to periodic reviews of situations where double taxation may recur and to take up any issue involving bilateral tax treaties, the Committee has prepared reports on the taxation of income from the leasing of industrial, commercial or scientific equipment and from the leasing of containers, which will be made public later in the year. Other work related to double taxation includes a detailed review of possible provisions for discouraging the improper use of tax treaties. The new OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts was published last Spring.

The Committee has continued to discuss a number of issues related to transfer pricing of multinational enterprises, such as the application of the 1979 OECD report on transfer pricing to the banking sector, the allocation of central costs, and the tax treatment of foreign exchange gains and losses. Co-operation with the Council of Europe for the establishment of a joint multilateral convention for administrative assistance in tax matters has continued. Other work related to international cooperation underway includes the continuation of a detailed study on the taxation of operations involving low-tax countries and discussions on the effect of bank secrecy for the administration of taxes, both domestically and internationally.

TAX ANALYSIS AND TAX STATISTICS

Working Party No. 2 on Tax Analysis and Tax Statistics of the Committee on Fiscal Affairs is responsible for carrying out work on the revenue side of government budgets, excluding macro-economic and conjunctural fiscal policy analysis which is the domain of the Economic Policy Committee. Under a new work programme the work of the Working Party can be grouped into three main inter-related topics: comparisons of tax systems and structures; taxation in relation to economic and social policy issues; estimation and quantification techniques. The common themes of the work programme are to review the options governments have on tax policy issues; to provide comparable information about the tax systems and structures of OECD member countries; and to exchange views or provide information on technical problems.

Recent work of the Working Party has concentrated on a number of specific subjects which have or are about to appear in the form of publications. A report on "Income Tax Collection Lags" was issued in July. It examines the delay between the receipt of income by the taxpayer and the payment of the tax arising on such income to the Government. The 1983 edition of *Revenue Structures in OECD Member Countries* was published in September. It covered the period 1965 to 1982 and included data on tax receipts for the years 1955 and 1960. Also in September, a report on "Taxes on Immovable Property" was published, which described the ways in which OECD member countries tax real property and analysed the various policy issues which arise in this area, with particular reference to the use of these taxes in financing local governments. Other publications to appear by the end of the year include the 1983 edition of *The Tax/Benefit Position of a Typical Worker* and a report on the "Tax Elasticity of the Central Government Personal Income Tax Systems" (to appear in the series *OECD Studies in Taxation).*

Work is underway on a key report concerning the interaction between personal income tax systems under changing economic conditions. The other main preoccupation of Working Party No. 2 during the next months will include the preparation of reports on the use of tax expenditure budgets, on the ways in which corporate tax systems can be compared and the difficulties in making international comparisons of effective corporate tax burdens.

CONFERENCE DIARY

NOVEMBER 1983

Management Centre Europe: Leasing (including: tax aspects). Brussels (Belgium), November 3-4 (English).

Management Centre Europe: International finance (including: tax implications of financing and foreign exchange transactions). Nice (France), November 7-9 (English).

Seminar Services International: International tax planning. Zürich (Switzerland), November 7-8-9 (English).

The American Tax Institute in Europe: 6th Annual Congress (including: international aspects of U.S. corporate taxation, tax developments in key European countries and unitary taxation). Cannes (France), November 16-17-18 (English).

Seminar Services International: Taxation of international financial transfers. Amsterdam (Netherlands), November 21-22 (English).

DECEMBER 1983

Management Centre Europe: International cash management (including: the role of international tax planning in tax management). London (United Kingdom), December 7-9 (English).

Management Centre Europe: International portfolio management (including: the role of taxation specialists). Brussels (Belgium), December 19-21 (English).

SEPTEMBER 1984

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and its subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). September 16-21 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

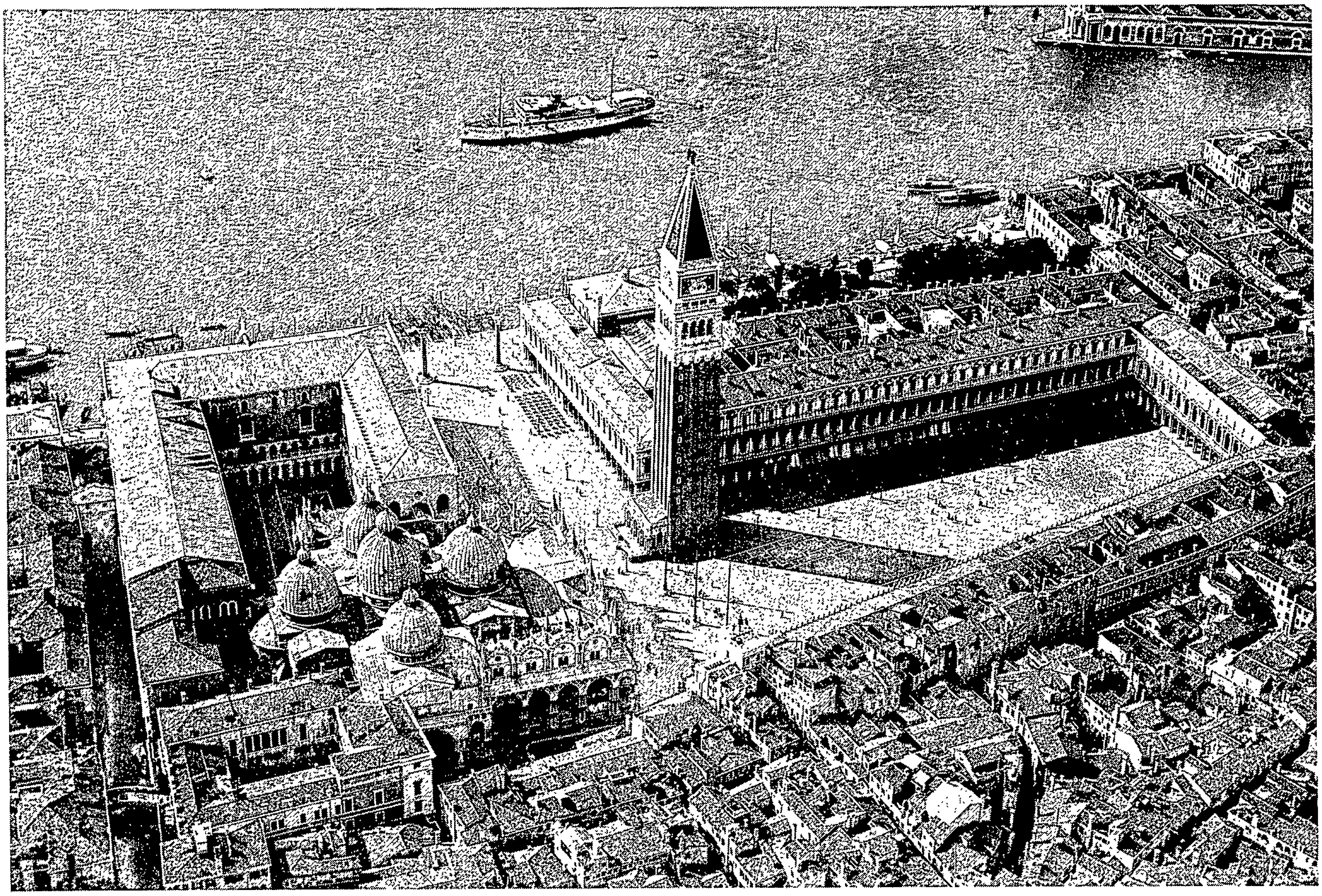
International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (the Netherlands).

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

Seminar Services Int'l.: 1 Passage Perdonnet CH-1005, Lausanne, Switzerland

IFA Congress 1983 Venice - Italy

AERIAL VIEW OF PIAZZA SAN MARCO



Subject I
Tax Avoidance / Tax Evasion

Subject II
International problems in the field of general taxes on sales of goods and services

Seminar A
Tax policy towards the national heritage

Seminar B
Tax aspects of foreign investment in Italy

Sujet I
Evasion fiscale / Fraude fiscale

Sujet II
Problèmes internationaux dans le domaine des taxes sur le chiffre d'affaires

Séminaire A
Politique fiscale et patrimoine culturel

Séminaire B
Investissements étrangers en Italie

Thema I
Steuervermeidung / Steuerhinterziehung

Thema II
Internationale Probleme auf dem Gebiet der Umsatzbesteuerung

Seminar A
Steuerpolitik und nationales Kulturerbe

Seminar B
Ausländische Investierungen in Italien

Tema I
Elusión fiscal / Evasión fiscal

Tema II
Problemas internacionales en los impuestos generales sobre las ventas de bienes y servicios

Seminario A
Política fiscal sobre el patrimonio cultural

Seminario B
Problemas fiscales de las inversiones extranjeras en Italia

Congrès Venise 1983

MAX LAXAN
Président de l'IFA

Les fastes du Congrès de Montréal sont encore vivants dans nos mémoires alors que nous allons retrouver, pour notre trente septième réunion annuelle, les chemins plus familiers de l'Europe. La ville qui nous accueille cette année est parmi les plus chargées d'histoire, les plus singulières par son passé, les plus prestigieuses par l'ensemble de monuments et d'oeuvres d'art qu'elle a légués au patrimoine de l'humanité. Rien ne prédisposait la lagune ingrate de Venise à briller d'un aussi vif éclat à travers les siècles que la volonté et l'énergie des hommes. C'est ce témoignage que je veux avant tout retenir.

Avec Venise, nous retrouvons aussi le charme d'un pays dont nos pérégrinations nous avaient écartés depuis de trop longues années, voilà presque trente ans que notre Association, alors dans son renouveau d'après guerre, n'a pas tenu de Congrès en Italie. C'est dire la joie que nous éprouvons à nous rassembler au coeur de la vieille cité dans ce mois d'octobre qui convient, mieux que les agitations de l'été, à la découverte de ses richesses artistiques comme à la conduite de nos travaux.

Les deux thèmes d'étude qui nous sont proposés ont déjà été éclairés par nos précédentes réflexions. S'agissant de la fraude et de l'évasion fiscales, le Congrès de Paris, en 1980, avait, dans son premier séminaire, disputé de l'usage et de l'abus du recours aux refuges fiscaux. Le sujet, cette fois, est pris dans sa plus grande dimension et couvre l'ensemble d'un domaine dans l'approche duquel les éléments passionnels l'emportent souvent sur les aspects juridiques, mais qu'il convient de traiter avec la rigueur scientifique qui est le propre de notre Association. Quant aux taxes sur le chiffre d'affaires, le Congrès de Rome, déjà en 1956, accessoirement celui d'Athènes en 1962, avaient conduit des travaux approfondis sur les problèmes internationaux qui s'y rattachent, mais en privilégiant l'aspect économique de l'imposition. Notre approche, cette année, sera plus classique.

Le remarquable travail effectué par le Professeur V. UCKMAR, sur la base des rapports établis par vingt sept groupements nationaux, offre un panorama complet et une analyse attentive et minutieuse des concepts de fraude et d'évasion fiscale. Il dégage les fondements juridiques sur lesquels s'établissent les mesures prises par les différents Etats développés, en vue de faire échec à des manoeuvres que la persistance des difficultés économiques, d'une part, le développement des courants d'affaires transnationaux, d'autre part, rendent à la fois plus tentantes et plus difficiles à combattre.

Si la fraude est assez aisément caractérisée comme un manquement direct, intentionnel ou non, à la loi fiscale, il est plus difficile de cerner le contenu des pratiques qui relèvent de l'évasion. C'est en effet le droit du contribuable de mener ses affaires de telle manière que l'impôt qu'il ait à acquitter soit le moins élevé possible. Cette conduite est qualifiée du joli terme d'épargne fiscale. C'est entre l'épargne et l'évasion fiscales que la frontière apparaît à bien des égards incertaine. Le contenu que les différentes législations donnent à l'évasion fiscale montre que, généralement, celle-ci est caractérisée par la mise en oeuvre de pratiques permettant de parvenir à un résultat qui aurait entrainé l'exigibilité de l'impôt s'il avait été obtenu dans le cadre d'une gestion normale des affaires. On ne saurait disconvenir de la nécessité pour l'autorité fiscale de prendre des dispositions propres à lutter contre certaines formes d'évasion fiscale. Encore faut-il que ces dispositions soient aussi claires et précises que possible de manière à éviter toute application arbitraire ou simplement discrétionnaire.

Les mesures destinées à protéger les intérêts des Etats contre la fraude et l'évasion fiscales internationales ont fait l'objet de la part du rapporteur général d'un inventaire détaillé et exhaustif, englobant des mesures à caractère liquidatif ou forfaitaire qui expriment peut être davantage le souci d'assurer un partage équitable entre les diverses souverainetés fiscales d'activités de caractère international. A la lumière des principes généraux précédemment dégagés, le Professeur UCKMAR analyse de manière pertinente la notion de "refuge fiscal" et les conséquences qu'en ont tiré les pays exportateurs de capitaux, de même que les limitations qu'ils apportent à une utilisation trop habile des mesures prises pour éviter les doubles impositions, à la suite de la multiplication des traités qui s'y rapportent.

Il est clair, enfin, que la lutte contre la fraude fiscale à l'échelle internationale ne peut connaître de réels succès que si elle s'appuie sur une coopération internationale qui s'est développée au cours des dernières années, mais qui comporte encore d'évidentes lacunes.

Le deuxième sujet livré à nos réflexions concerne les problèmes internationaux relatifs aux taxes sur le chiffre d'affaires. Le rapporteur général, le professeur H.G. RUPPE, opérant une synthèse magistrale des vingt trois rapports nationaux, constate tout d'abord que la communauté internationale reconnaît que les taxes sur le chiffre d'affaires s'analysent comme des impôts généraux à la consommation qui, en vertu du principe de la territorialité de l'impôt, doivent frapper les produits importés comme les produits nationaux et ne pas être perçus, au contraire, sur les marchandises exportées. C'est l'application de la règle de la fiscalité du pays de destination.

Cette règle est de portée très large: elle concerne aussi bien les taxes cumulatives sur le chiffre d'affaires, dont le domaine se rétrécit, que la forme la plus élaborée de ce type d'imposition, la taxe sur la valeur ajoutée, qui, sous ses différents types, est de plus en plus répandue, depuis que l'harmonisation de la fiscalité indirecte des pays de la Communauté Economique Européenne s'est ordonnée autour d'elle. Dans tous les cas, à travers l'entreprise redevable de l'impôt, c'est la contribution du consommateur final qui est recherchée, ainsi qu'en témoignent les exonérations qui en limitent le champ d'application et surtout les taux différenciés qui tendent à rendre plus équitables les prélèvements opérés.

La généralisation de la taxe sur la valeur ajoutée a réduit la portée des problèmes internationaux relatifs aux taxes sur le chiffre d'affaires dans la mesure où la technique de sa perception dispense, tant à l'entrée qu'à la sortie des marchandises du territoire national, de procéder d'une manière forfaitaire à l'imposition ou à l'exon des taxes cumulatives ayant pu frapper le produit aux stades antérieurs de son élaboration. Aussi bien, dans les relations entre pays ayant recours à la taxe sur la valeur ajoutée comme mode d'imposition des affaires, les difficultés rémanentes, que le rapporteur général recense avec soin, ne sont que de portée limitée. Le risque de double imposition, ou au contraire de non-imposition, concerne surtout, comme le montre avec pertinence le professeur RUPPE, les prestations de services. En ce qui les concerne, la compétence fiscale peut être revendiquée par le pays où le prestataire a son siège, par celui où le service est rendu ou par celui où le service est utilisé.

L'hésitation que l'on peut avoir, s'agissant surtout des prestations immatérielles, dont le développement des techniques a multiplié le nombre, à localiser le service, a amené la Communauté Economique Européenne, dans sa sixième directive, à définir un ensemble de règles très complexes sans toujours parvenir à un résultat satisfaisant.

On doit savoir gré au professeur RUPPE d'avoir, en conclusion de son rapport très intéressant et très complet, cerné les différents domaines dans lequels des progrès peuvent encore être accomplis si l'on veut parvenir à une plus grande neutralité des taxes sur le chiffre d'affaires.

Il n'en reste pas moins que les problèmes internationaux que soulève ce secteur de la fiscalité demeurent d'une ampleur assez réduite et qu'il suffit sans doute à la qualité du travail scientifique de notre Association qu'il soit fait, périodiquement, sinon à intervalle d'un quart de siècle, le point de l'évolution des techniques et le recensement des difficultés.

A côté des deux thèmes d'études principaux, se tiendront, comme il est d'usage, deux séminaires. Celui consacré aux investissements étrangers en Italie répond à une tradition constante du pays hôte de mieux faire connaître le contenu de sa législation fiscale dans ses développements les plus récents.

Aussi, insisterai-je surtout sur l'intérêt exceptionnel que présentera le séminaire sur la politique fiscale et le patrimoine culturel, auquel nos amis italiens ont souhaité donner le plus grand retentissement en lui consacrant l'après-midi de la première journée. Où, mieux qu'à Venise, pouvait-on illustrer les efforts faits pour promouvoir, par le biais de l'impôt, la sauvegarde des richesses artistiques dont nous sommes les dépositaires?

A tous les participants, comme aux personnes qui les accompagnent, je souhaite un excellent congrès et le plus agréable séjour dans la cité des Doges.

Congress of Venice 1983

While the festive proceedings of the Montreal Congress are still vivid in our minds, we are returning to the more familiar roads of Europe for our 37th annual meeting. Our host city for this year is one of the most historic, with a highly distinguished past, and has the most marvelous monuments and works of art which it bequeathed to the heritage of mankind. Nothing but the will and energy of men has predisposed the barren lagoon of Venice to glitter with such lively brilliance throughout the centuries. Above all I want to remind everyone of this heritage.

In Venice we rediscover the charms of a country from which our travels have kept us away for too many years, as our Association has not held a Congress in Italy for almost 30 years following its revival after the war. That is why we take such pleasure in meeting in the heart of the old city in the month of October which far better suits the discovery of the artistic riches of Venice and the carrying on of our business than the busy summer months.

Our previous meetings have already thrown some light on the two subjects which were proposed to us. In 1980 the Paris Congress dealt with tax avoidance and evasion when it discussed in its first seminar the use and abuse of tax havens. This time the subject is taken in its widest sense and covers the whole of a field in which emotional elements often prevail over the legal aspects but which should be treated with the scientific exactness that is the hallmark of our Association.

As to turnover taxes, both the Congresses of Rome (as long ago as 1956) and of Athens in 1962 did some thorough work on the international problems attached to them, but with special attention to the economic aspect of the imposition. This year we will take a more standard approach.

The remarkable work carried out by Professor V. Uckmar, which was based on twenty-seven national reports, offers a complete panorama and a careful and detailed analysis of the concepts of tax avoidance and evasion. He defines the legal foundations on which are based the measures taken by the various developed countries with a view to checking schemes which are made both more tempting and more difficult to combat by the persistence of the economic difficulties on the one hand, and the development of transnational business on the other.

If tax evasion can quite readily be characterized as a straightforward violation of tax law, whether intended or not, it is more difficult to define those practices that fall under the concept of tax avoidance.

It is in fact the right of the taxpayer to conduct his affairs in such a way that the taxes he has to pay are as low as possible. This behavior is qualified by the nice phrase "tax saving". The borderline between tax saving and tax avoidance proves to be vague in many aspects. The contents attributed to the concept of tax avoidance by different legislation show that, in general, it is characterized by putting into operation practices which make it possible to achieve a result which would have led to taxation if it had been achieved under normal conduct of a business. One cannot gainsay the necessity for the tax authorities to take proper measures to combat certain forms of tax avoidance. These measures should also be as clear and precise as possible so as to avoid any arbitrary or merely discretionary application.

The general reporter has made the measures aimed at protecting the interests of States against international tax avoidance and evasion the subject of a detailed and exhaustive inventory. This includes measures which result in a final settlement or a fixed solution which perhaps further expresses the worry of assuring a fair division between the various tax jurisdictions of activities of an international character.

Along general principles which he first sets forth, Prof. Uckmar analyses in a relevant way the notion of "tax havens" and the consequences which the capital exporting countries have drawn from it, as well as the limitation which they apply to a too clever use of measures to avoid double taxation as a consequence of the increasing number of treaties which relate to it.

Finally, it is clear that the battle against tax evasion on an international scale cannot be truly successful unless it depends on international cooperation which has indeed developed in the course of the last few years, but which clearly still shows gaps.

The second subject submitted for our consideration concerns international problems relating to turnover tax. The general reporter, Professor H.G. Ruppe, who has carried out a masterly synthesis of twenty-three national reports, states first of all that the international community recognizes that the various types of turnover tax can be characterized as general consumption taxes which, under the principle of territoriality of tax, should be levied on domestic as well as imported goods but not on exported goods. This is the application of the rule that the country of destination has the right to tax.

This rule is very widely applied: it concerns cumulative turnover taxes – whose field is shrinking – as well as the most sophisticated form of this type of taxation, i.e. the value added tax, which under various forms has been adopted by an increasing number of countries, and is the focal point around which the harmonization of indirect taxation in the European Common Market countries is effected. In all cases, it is sought to place the burden of the tax on the final consumer through the enterprise which is the payer of the tax. This is evidenced by the exemptions which limit its field of application and in particular by the differentiated tax rates which lead to fairer taxation.

The spread of the value added tax reduced the significance of international problems regarding turnover taxes in so far as their collection system released governments from the obligation to use forfait systems when taxing or exempting goods, respectively imported in the national territory or exported from it, with respect to cumulative turnover taxes which could be imposed on such goods in earlier stages of their production. Besides, the remaining difficulties, which the general reporter carefully describes, in the relationships between countries which have adopted a value added tax to tax business transactions have only limited significance.

The risk of double taxation or, by contrast, non-taxation, concerns in particular the supply of services as clearly shown by Professor Ruppe. With respect to the latter, the right to tax may be claimed either by the country where the supplier is established or by the country where the service is rendered or by the country where the service is used. Any doubts which one might have with respect to the place where the service is rendered concern in particular "immaterial services", the number of which increases as a result of technical developments. This has caused the European Common Market to define a number of very complex rules in its Sixth Directive, without, however, always obtaining a satisfactory result.

One must be grateful to Professor Ruppe for having pointed out, in the conclusion to his very interesting and complete report, the various fields in which progress can still be made if one wishes to arrive at a greater neutrality of turnover taxation. It can, however, not be denied that the international problems which are caused by this sector of taxation are less significant and there is little doubt that the quality of the scientific work performed by our Association will not be impaired if it only periodically, even at intervals of a quarter of a century, takes stock of the technical developments and makes an inventory of the difficulties.

In addition to the discussion of the two main subjects there will be – as is our custom – two seminars. The one dedicated to foreign investment in Italy is in conformity with the tradition that the host country acquaints interested parties with its tax legislation and its most recent developments.

But, I would like to emphasize in particular the exceptional importance of the seminar on tax policy vis-à-vis the cultural heritage, to which our Italian friends have wished to give the greatest prominence by dedicating the afternoon of the first day to it. Where else than in Venice could one better illustrate the efforts to promote through taxation the safeguarding of the artistic riches of which we are the trustees?

I wish all delegates as well as the persons who accompany them an excellent congress and a most agreeable stay in the city of the Doges.

Tax Policy in Italy

By Francesco Forte

Francesco Forte, currently Minister for EEC Affairs, was born in Busto Arsizio (Italy) in 1929. He obtained his degree at the University of Pavia in 1951 and became full professor at the University of Turin in 1961. He is the author of many books and publications.

Mr. Forte was Vice-President of ENI from 1971-1975, President of the textile holding of ENI from 1974-1977, member of the Central Tax Commission from 1977-1979 and took part with Messrs. Marjolin and Mc Dougall in 3 study committees of the EEC on monetary union and development of the European budget (1975-1979). He is also a member of the Scientific Board of the University of Buckingham (United Kingdom), Vice-President of the Atlantic Economic Association, and President of the Italian Society of Economy, Demography and Statistics.

Mr. Forte is a member of the Italian Socialist Party and has been a member of the Chamber of Deputies for his Party since 1979. He was President of the Industry Committee of the Chamber of Deputies from 1979-1981.

He was Minister of Finance from December 1982 to August 1983.

The first subject of this Congress – tax avoidance and tax evasion – is undoubtedly quite suitable as regards Italian taxation policy in this period. Indeed, one of the main themes we are dealing with is precisely that of the elimination or reduction of the areas of tax erosion due both to elusion and to apparently unjustified exemptions (or even to the combination of these two elements) and with evasion.

In this connection I have coined a term that I believe could be considered useful in debates between researchers and experts, who have the task of evaluating the tax policy in its application and in its trends: the term "areas of tax penumbra". The sun of the South does not shine upon all areas of tax-paying capacity. On some there shines a setting sun, on others the sun tries to illuminate, but it is hindered by large wandering clouds; on yet others – as on the fields of Marengo after the historical battle – "pale shines the moon". Over others there is darkest night. When a tax and social contribution system has reached, as has the Italian system in 1983, a burden level of around 44% of the national product, the areas of tax penumbra now appear particularly worrying, because:

(1) There is an increase in the economic distortions and inequalities between those who pay and those who do not pay or pay little because they are in the area of tax penumbra or even in the area of "darkest night".
(2) There is a greater need to reduce or eliminate the areas of tax penumbra, to obtain new revenue without putting pressure on already paying taxpayers (this in Italy, not to increase the tax burden, but rather to replace with normal taxation the forms of extraordinary or temporary taxation).
(3) It is becoming more urgent to act against the tax penumbra and night, so as to have the means for adapting taxes to the reality of the economy, stimulating the growth of assessable incomes (which we believe can be done, in most cases, by simplifying matters and by using average income notions, following the tradition of Italian science on optimal taxation, from Gian Rinaldo Carli and Pietro Verri onwards).

To understand the problems and the objectives of tax policy, one must consider the difficulties of the Italian balance of revenue and expenditure, and the fact that in Italy a great tax reform was started just at the beginning of the 1970s, when enormous factors contributing to economic tension occurred, such as the shock caused by the increase in oil prices.

In Italy, in the period of the "easy years" (1971-76), the tax burden remained at 17% and social security contributions at 14%, while public expenditure continued to increase, reaching average European levels. Our tax and contribution pressure has instead remained considerably below average European levels, as well as below the average level of the previous 20 years. In fact, in 1953 the tax burden was at 18.2%, in 1963 at 20.3%. This caused a deficit that reached figures never before seen in our country. The speed of growth and the difficulty in reducing this deficit were of a structural order, due to the great difference between revenue and public expenditure: the latter grown to European levels, the former remaining below them. The burden of public debt increased through inflation, and this element contributed to the growth of the deficit. But we cannot ignore the fact that the effect of inflation in its turn depended on the fact that, unlike other countries, we were unable to control the first and second oil price shocks adequately, since in our country there were elements which prevented the economy from functioning properly: a deficit substantially due to a permissive policy on revenue which was incompatible with public expenditure policy and indexing mechanisms and rigidity in the cost system that in fact stimulated cost inflation.

If we consider the Italian budget today, we find a quite different situation. Public expenditure has maintained the European levels, rising a few points above the previous level. This growth of a few points is simply due to the fact that the national product growth rate is at zero level, – unfortunately because of various circumstances – and the expenditure feels the effect of a historical momentum, because of predetermined mechanisms that admitted a real growth rate of around 3%, and not less. Gradually, thanks to the efforts made since 1981 and particularly last year, and – may one say so – this year, we have today reached a level of tax and contribution burden very similar to that of the rest of Europe. At the present moment, for tax revenue we are at 28.5% approximately, and for tax and contributions at about 43.5%, which is hardly comparable with the 30%-31% of the easy years. By now, however, our budget is burdened by interest on public indebtedness equal to more than 8% of the national product.

This is caused by errors made in the past, in part during the easy years, and the almost schizophrenic policy then followed, and in part in later years through inflation due to various causes, among which were the deficit, the indexation mechanisms and other factors that have brought us to a disproportionate rise in the cost of money.

To recover from this situation, one should first of all maintain revenue at the level reached this year; thus tax policy, as has happened, should be oriented towards the ends of an economic policy to reduce demand and money inflation and to accomplish a "social pact" for an income policy, i.e. the elements of cost inflation and thus bring about a fall in inflation that in its turn can produce a fall in the cost of money; in this way, the burden of interest on public indebtedness will tend to lessen in terms of percentage of the national product, and then we will be able to bring our budget balance back to normal.

This is the line we are following. One should remember, however, that we have to deal with the inheritance from the easy years and that therefore we now have to face requirements and tasks that are not pleasant for anybody. These tasks must be faced realistically.

I should mention that, when Mussolini came to power, all political forces were discussing extraordinary financial measures, and the fascist programme itself contained measures of extraordinary finance as had the previous ones.

The financial history of that and later periods in Italy shows that financial normalization occurred thanks to the measures of ordinary finance of previous governments and to the ordinary financial measures developed by Minister De Stefani. Thus, extraordinary financial measures were of no use in that post-war period. The same considerations apply to our second post-war period. Let us remember that in economic and financial history, extraordinary finance does not exist: there are only the ways of ordinary finance, more or less easy, more or less lengthy.

This I say, because one should not avoid our daily medicine, imagining a marvellous, future, all-resolving medicine.

The measures taken in early 1983 to correct IRPEF (personal income tax) are not pointless. They increase individual purchasing power with a large operation reducing personal income tax and increasing family allowances. Unions traded these concessions with change in indexation mechanisms of cost of labour and in the elements of rigidity contained in our labour contract system. This is not only significant in itself, but is also an important signal of a change in trend. In this way in Italy we have adopted – we may, I think, say so without arrogance – for the first time in the Western world a type of income policy different from that called – let us face it – "neocorporative", which consists in the direct intervention of the Government by suggestion or even by law in the relationship between the different parts of society. Our intervention instead consists in an income policy system wherein the Government acts through its own instruments of tax policy and welfare policy. Therefore, it encourages and modifies the elements of income policy through public finance action. As far as I can see, among the various experiments of income policy analyzed till now, this is a novelty. It is also an important fact, as it shows that it is possible to act with an income policy though respecting independent contracts. This is a very important point for those of us who believe in both the principles of economic freedom of enterprise, and in the principles of freedom and independence of trade unions. We believe that Government interventions should have certain limits so as to respect certain basic automatic rules of the market system. And, as Italians are more prone to vice than – let us say – the Austrians, "neocorporative" models in Italy might be apt to degenerate, while this model may have its costs, possibly higher than others, but it gives results that are less prone to deviation than others.

This operation at the same time aimed at redistribution of income – as one may see – from the point of view of tax equity. In Italy, for various reasons, the main part of the tax load burdens individual taxpayers, of which by far the greatest part fell on employees. Thus it was important, on the one hand, to amend somewhat the income tax system, and on the other hand to have measures in favour of employees. In addition, to meet justified requests in this field, relief was given in the form of family aid, mainly for single-income families, to ease family burdens. It seems to us that this instrument may at times be more important than the tax instrument, as it can be better tuned to requirements inherent to family situations.

The theme of controlling public expenditure, which has been thoroughly discussed and dealt with, is also for us of utmost concern. It is obvious that the size of the Italian public expenditure compared to the national income is such that controlling it is essential. I should, however, point out that the main theme of this control, from the point of view of quantity, lies in the reduction of interest on the public debt so as to promote (together with the high tax burden that should be kept up) the virtuous spiral of the reduction of the public debt burden and interest. And, as every percentage point is worth 4,000 billion lire, if one considers compound interest and its effect on corporations owned or part-owned by the State, this is where the main action should concentrate. But, of course, it is also very important that public entrepre-

TAX REVENUE FROM 1974 TO 1982

In billions of lire

	1974	1975	1976	1977	1978	1979	1980	1981	1982[1]
Direct taxes									
IRPEF (personal income tax)	2,901	4,185	6,776	10,098	11,616	15,095	23,402	31,120	38,351
IRPEG (corporation income tax)	133	651	907	1,602	1,275	1,620	2,962	3,550	4,506
ILOR (local income tax)	105	270	484	379	3,344	3,481	4,394	5,433	6,941
Substitute tax	31	1,033	2,151	2,742	4,158	3,861	6,040	8,314	10,755
Others	3,111	1,788	1,261	1,196	1,459	1,972	793	851	4,599
TOTAL	6,281	7,927	11,579	16,017	21,852	26,029	37,591	49,268	65,152
% on total	33.7	40.2	41.8	44.7	49.0	50.0	52.4	54.9	57.2
percentage increase compared to the previous year	42.3	26.6	46.1	38.3	36.4	19.1	44.4	31.1	32.2
Indirect taxes									
VAT	2,295	2,339	7,066	9,334	10,858	11,894	17,382	20,672	24,712
Registry Department	523	555	818	923	1,123	1,431	1,997	2,590	1,978
Stamp duty	383	444	547	857	1,101	1,296	1,444	1,724	2,369
Mineral oils	2,494	2,898	3,627	4,531	4,951	5,780	6,617	7,071	8,400
Tobacco excise tax	863	1,008	1,130	1,318	1,528	1,760	2,038	2,536	3,270
Others	5,788	4,550	2,908	2,883	3,224	3,878	4,720	5,867	7,943
TOTAL	12,346	11,794	16,096	19,846	22,785	26,039	34,198	40,460	48,672
% on total	66.3	59.8	58.2	55.3	51.0	50.0	47.6	45.1	42.8
percentage increase compared to the previous year	25.2	−4.5	36.5	23.3	14.8	14.3	31.3	18.3	20.3
GRAND TOTAL	18,627	19,721	27,675	35,863	44,637	52,068	71,789	89,728	113,824

1. Provisional data (1982)

neurs and managers in general should be made aware of their responsibility in the overall situation.

Waste and abuse are also fundamental elements to tackle. Thus in the policy we have adopted there is the principle of tax autonomy and fiscal responsibility of every independent centre of expenses. Our thought therefore is, that in future one should not grant to local authorities automatic transfer increases, but only assessable incomes or other taxable matters, so that the principle is upheld that the citizen who is a taxpayer can himself directly go and check who is spending and how. For instance, we know that in regional administrations there is a practice that the State does not allow: the use of means of transport, such as a motorcar with chauffeur, on routes one could cover by train, for which in the State administration different and stricter procedures are used instead.

But the theme of public expenditure at times arouses bitter thoughts in those who have to run Government programmes, because everyone is in complete agreement when stating general principles, far less when one gets to specific cases.

It is true that Parliament has become an instrument for aggravating taxes, but one cannot help noting that unfortunately at times it is also an instrument where expenses are voted without realizing that they mean taxes: this concept is also valid for tax exemptions and deductions.

One may recall the story of the person who had a lot of hair, from whom one hair at a time was taken away, until at a certain moment he was bald. This idea also holds in tax matters taken one at a time, every measure may be considered a small thing, but if we continue to pluck hairs we will end up bald.

For instance, it is obvious that if the famous "una tantum" tax of 2,000 billion lire is not applied, we will lose 2,000 billion lire. It is obvious that if we do not replace the 600 billion lire of additional exemptions in favour of income derived from professions and small firms, we will lose 600 billion lire, and that if we do no complete our programme for the recovery of VAT evasions of 600 billion lire, we will lose another 600 billion lire. We have obtained approval of and we are beginning to apply the law regarding sealed cash registers. The revenue that can be collected through this cannot as yet be specified, but, all the same, this is to be considered an important revenue yielding measure.

Some have criticized the increase of the tax on lighters. This means 40 billion lire. Whoever can suggest alternative sources of revenue is asked to kindly say so, when criticizing any particular tax.

Rightly, Luigi Einaudi wanted our Constitution to contain a norm specifying that budget choices should be made comparing expenditure and revenue.

As regards our program it now consists first of all in the official redaction of unified tax codes, the first of which concerns personal income tax.

Apart from this important programme of law reorganization, we have the following 6 plans.

First come the amendments to the law reorganizing the financial administration to render it more efficient and operational.

It is fundamental to acquire not only the instruments for unifying assessments on VAT and income tax matters, but also the instruments for acquiring in a quick, unbureaucratic manner, as if in a large company, the means needed for the complete informatic reorganization of the financial administration. This not only concerns computerization of registers as those concerning real estates but also tax litigation, personnel management, field operations. We require different procurement procedures. One only needs to think that, to purchase a *personal computer*, one has to wait one and a half year; so that when there is need of one in certain departments, one has to resort to borrowing, which undoubtedly is hardly the ideal solution.

Another measure concerns tax collection. This is a re-appraisal of pending legislation. We consider it very important as it extends the procedure of collection by tax-roll to all revenue outstanding, and it strengthens the structures and elements of competition among tax collection entities, safeguarding the principle that collection should be entrusted to banks, public corporations and to cooperative bodies, the professional competence of which is beyond question.

Moreover, we have prepared the text of the reform of tax litigation, which will reduce litigation to two steps, thus saving time and increasing efficiency, as well as utilizing better the personnel. The remainder of personnel will be assigned to assist the ordinary magistrate in fiscal cases to support his increased burden with regard to tax matters.

There is moreover the regrouping and reduction of the number of VAT rates, and anti-evasion measures for VAT in foreign trade. This is accompanied by the preparation of indexes of profitability and of living standards as regards the income tax sector. These are sensitive areas, wherein we act bearing in mind principles of objectivity. The same spirit pervades the methods of assessment by parameters of average income for purposes of the new municipal tax on real estate entrusted to local authorities.

There has been a debate on the new norm about inductive assessments. First of all, I must say that this norm is derived from the tax reform law. We do not think we have to use it either in a demagogic way or in an exaggerated manner; we simply believe we must employ coeffi-

TAX BURDEN AND CURRENT PUBLIC EXPENDITURE

In billions of lire

Years	*State Revenue*	*Public Administration Revenue*	*Social Security Contributions*	*GDP*	*Taxes*	*Taxation Contributions*	*Total*	*Current Public (P.A.) Administration Expenditure in % of GDP*	*Current Public Administration (P.A.) Deficit in % of GDP*
	(a)	(b)	(c)	(d)	(e=b:d)	(f=c:d)	g=(b+c):d		
1971	—	11459	8500	68510	16.7	12.4	29.1	33.8	1.8
1973	14276	14303	11341	82503	17.3	13.7	31.0	35.0	3.8
1974	18627	17919	14206	101723	17.6	14.0	31.6	35.0	3.5
1975	19721	19402	17569	125378	15.5	14.0	29.5	38.9	7.0
1976	27675	27355	21910	156657	17.5	14.0	31.5	38.6	4.9
1977	35863	35943	26191	190083	18.9	13.8	32.7	39.1	4.2
1978	44637	44776	31081	222254	20.1	14.0	34.1	42.3	5.6
1979	52067	51975	39227	270198	19.2	14.5	33.7	41.6	5.3
1980	71789	72173	47814	339078	21.3	14.1	35.4	42.0	3.9
1981	89728	89765	56744	398125	22.5	14.3	36.8	46.6	7.4
1982	113824	113800	69000	467000	24.4	14.8	39.2	48.6	7.0
1983	152252	147200	81100	534900	27.5	15.2	42.7	49.6	4.7

Notes: State Revenue receipts refer to assessments. For 1983 they do not discount the effects of the revision of IRPEF (personal income tax) quotas; they include proceeds from the extraordinary equalization tax; they do not include the measures for the further fiscalization of the reduced price of oil and the incorporation of the VAT quotas.

The figures given for Revenue, P.A. Expenditure, and GDP for 1982 and 1983 are partly the result of independent evaluations, and partly taken from the 39th ISCO Report to CNEL.
The calculation of the total tax pressure does not include revenue pertaining to the E.E.C.; this amounts to about 0.8% of the GDP.

cients concerning consumption through reasonable analytical constructions – because the inductive method can also be as analytical as the deductive method. In our programme, the two concepts are not opposed, nor do we want them to be, thus giving rise to negotiated agreements or tugs-of-war. Instead we want to use them with moderation to supplement analytical methods. Where an income is deduced from a series of known elements of consumption which is disproportionate to the amount declared. However, it is understood that induction cannot have a complete probatory value, because we realize that many incomes are subject to withholding tax at source in the form of tax paid in advance.

The Decree which was issued at the end of 1982, and which ensured the revenue enabling the Government to introduce the large IRPEF (personal income tax) cuts mentioned before, introduced an excise tax on a list of electronic and photo-optic apparels that some people have criticized. But the trend of these last 10-15 years to be found in financial science and in economic policy debates, accompanied by the fiscal crisis of the State, the growth of public expenditure and consumption in society, is in favour of a reassessment of taxes on consumption in its selective forms.

The writer had the honour of submitting the part of the report concerning indirect taxation to the Commission for tax law reform in 1964. I then drafted the two taxes that were later called IVA (VAT) and ICO (the new communal tax on consumption). When the tax reform was implemented it became detached from the original project and ICO was not adopted. The original tax reform also included the tax on buildings which is now being reintroduced in favour of local authorities.

To sum up, I would like to return to that original concept of the tax reform in which I have never ceased to believe, also because events have shown me right. However, we intend making a moderate use of excise taxes in a selective way, to take into consideration the international system of trade of which we are part. We must also add that the new excise tax (IEC) is a useful instrument for regrouping of the VAT rates and the connected simplification of VAT. To avoid the 38% rate on some products, we intend to use IEC. In other cases, we would give up the increased rate, as we do not believe that taxing certain products at 38%, such as truffles, smoked salmon, lobsters and caviar, is worth the trouble: the more so, as this increased tax rate is largely deductible as it mainly applies to consumption in restaurants. Also, the tax authorities cannot take an interest in so many individual details.

We intend to simplify as far as we can the tax system that by its own nature tends to be of a complex kind.

Another measure implemented by Decree at the end of 1982 consisted in transforming the car tax from a circulation tax to a tax on ownership. It is not true that this tax has thus become a capital tax, neither is it true that it has been separated from the principle of benefit for the use of roads. Precisely the contrary is true: the use of roads is not a function of the fact that an individual at a certain moment decides to circulate, but of the fact that an individual owns vehicles *capable of circulating* that come into operation causing traffic jams in the peak periods. Just as trains and aeroplanes are kept capable of peak period loads, similarly roads are built in proportion to requirements in peak period conditions. Thus, traffic police and road maintenance, etc. are also determined with reference to the additional problems that occur in peak periods. Particular road costs, such as the maintenance of curves, crossings, level-crossings and so on, depend on congestion elements and not on traffic in quiet hours.

Thus, measuring the tax on the basis of ownership of a vehicle capable of circulating is the best way to align it with the principle of benefit, without considering that, with this technique, we can gradually eliminate evasion which, at present, reaches 40%. One should not now say that the lesser tax paid amounted to 40%, because there were many who in actual fact kept at home old vehicles. Evasion actually is particularly high and sometimes is more than 40% in the sector of diesel motorvehicles that, on the one hand, generally are not old because of recent production, and, on the other hand, are normally intensively used, because they must pay a circulation surtax that, on a low mileage, would make their purchase uneconomical.

If there is this enormous evasion in the *diesel* sector, it means that the taxation system is inefficient; changing the tax collection technique, we can fight evasion efficiently. It is generally agreed that this fight does not depend only on goodwill and having offices, but is also connected to the use of suitable techniques of assessment and tax collection.

We now come to the theme of the withholding tax introduced by the law enacted at the end of 1982 and applicable to commercial brokers, agents and representatives. Doubts exist and questions, sometimes justifiable, have been raised with respect to this withholding for the first time, applied to income other than employment income or income derived from independent work or investment income. Thus it has been said that it taxes gross income. But I can reply that the same happens for income from independent work; the important thing is that the rate withheld is in proportion to the net income.

As regards income from independent work, someone remarked that in the Decree of end 1982 on IRPEF sufficient consideration had not been given from the point of view of the correction of curves and the grant of deductions. This was true. But one should remember that the original text was what was born immediately from the agreements on the cost of labour. It should have been completed. The continuation of the parliamentary debate allowed us to improve it.

In Parliament, we later passed an amendment with respect to the rates of income tax, for incomes between 22 and 30 million lire.

Examining the situation of a single employed person (a typical situation not containing other elements to disturb the picture), one notes that the greatest benefit from the amendment goes to the class between 22 and 40 million lire. It amounts to 2.76% on 22 million, 3.20% on 24 million, 3.07% on 25 million and comes to 2.48% to 2.52% on the upper incomes until it reaches 2.34% for an income of 40 million; previously these percentages were around 2% and 1.80% for this group of taxpayers.

We then introduced an amendment to the local income tax (ILOR) concerning small firms, which gives special incentives to take apprentices.

Finally, we must underline the passing of the law on the tax free revaluation of the capital assets of companies related to inflation, which in itself is an important instrument of financial renewal, together with the law on personal investment funds.

As regards the overall programme, it often has been said that these are either temporary or makeshift affairs.

I would ask those who said so to read the various norms and projects, to see together with me whether these are temporary or not. It seems to me that there are very few temporary things here; that these are all measures that are already proving useful this year and will be even more so as time passes. They are measures (some of them partially complete) for the purpose of creating something useful, above all, to reduce the areas of erosion of assessable incomes and the areas of evasion, as well as the zones of tax penumbra that originate from the contact of erosion with evasion. This may mean, as for certain laddered garments, a knitting together, which naturally can give the feeling of being makeshift, but that instead forms part of a definite overall project.

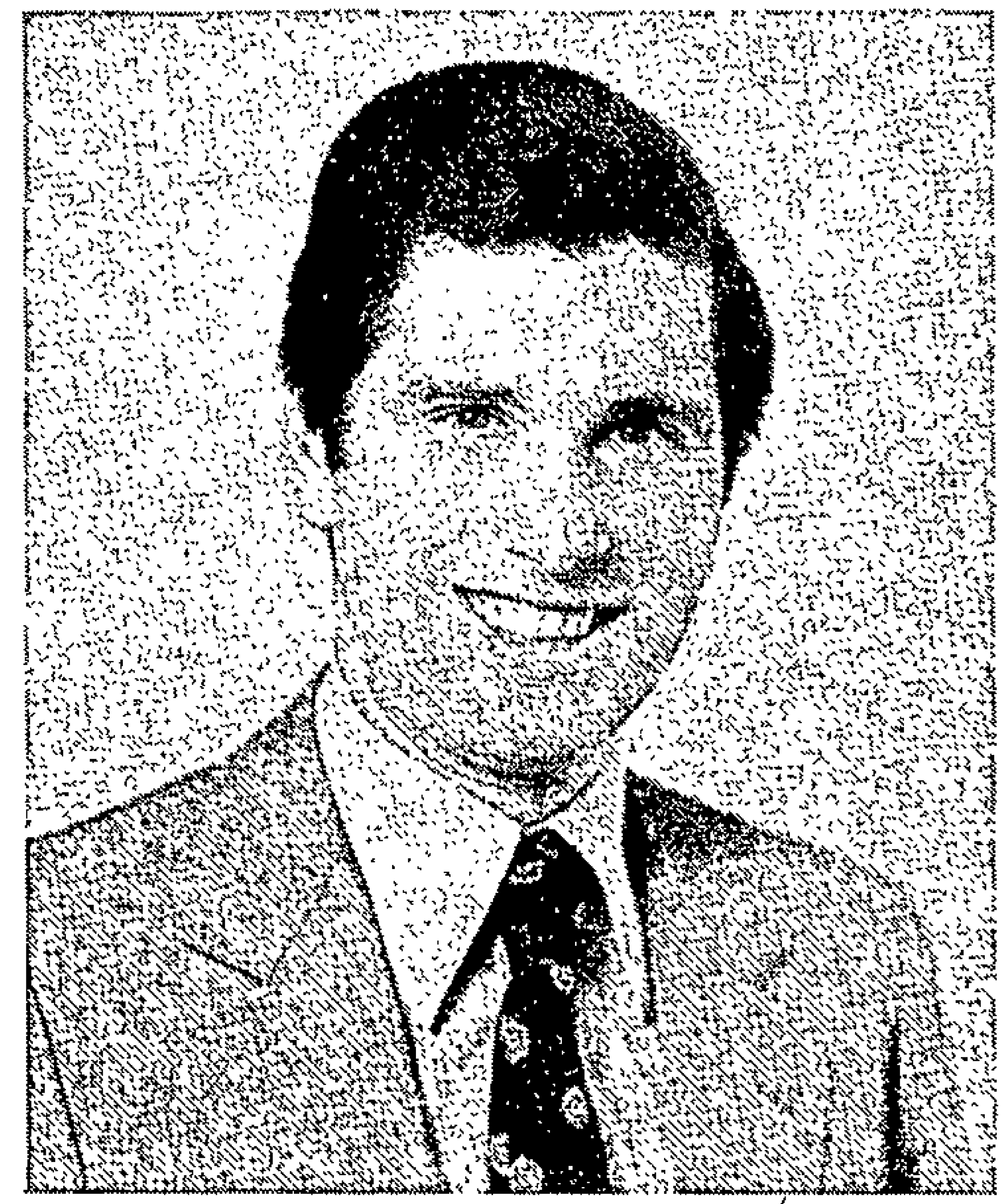
The project, I would like to repeat, was and is that of gradually reducing the areas of erosion and evasion, and of thus better distributing the tax load, of increasing at the same time the automatic devices of tax collection, as well as increasing the elements of automatic control as compared to those of case by case examination.

We have and are trying to discuss patiently every measure, willing to carry out amendments whenever possible. I would not want this method to be taken to be a kind of indecision in respect of our very firm belief that this system of measures – those adopted and those planned – is essential (at least until proven to the contrary) both for the better distribution of taxes and for reducing inflation. The return to an economic and social balance is at the basis of the recovery Italy can and must achieve, entering thus into the international group for which a recovery is now in sight.

Let us remember the period of errors, the easy and permissive years of high flying, during which revenue was reduced while expenditure increased. Let us remember it, to act now with rationality and pragmatism, through an overall project, but also through the specific action consisting of so many particular things, on which we must choose and we ask to choose here and now.

General Principles for the Determination of Business Income in Italy

By Antonio Lovisolo



Antonio Lovisolo was born in 1947 in Genoa (Italy). He is currently an attorney-at-law and practises with the law firm *Studio Legale Uckmar.* Mr. Lovisolo obtained his law degree in 1970 at the University of Genoa and wrote his thesis on the science of finance and financial law. Since 1970-1971 he has been a member of the Institute of Tax Law of the Faculty of Law of the University of Genoa. In 1980 he was appointed Professor of tax law at the Faculty of Economic and Financial Science of the University of Siena.
Since 1980 he is secretarial editor of the journal *Diritto e pratica tributaria.* He acted as a reporter at various congresses and is the author of numerous articles in Italian and foreign journals, as well as *Il sistema impositiva dei dividendi* (1980) which was awarded the "Antonio Uckmar" price.

The provisions in the fifth chapter (Art. 51, etc.) of the Law relating to the determination of business income undoubtedly constitute the nucleus of Decree No. 597 of 29 September 1973 (which contains the personal income tax – IRPEF – system), both because of the objective importance of such income, and because these provisions contain principles which are relevant to the corporate income tax (IRPEG: Decree No. 598 of 29 September 1973) and the local income tax (ILOR: Decree No. 599 of 29 September 1973) systems.

These rules relate to both the characterization of business income, and the determination and valuation of its various (both positive and negative) components.

The provisions concerning business income should be directed towards realising the principle of "conformity of taxable income with that calculated according to major economic principles, bearing in mind the need for efficiency, reinforcement and rationalisation of the productive entity" which, according to the Tax Reform Law (Art. 2 No. 16, Law No. 825 of 1971), should characterize the determination of income derived from the conduct of commercial enterprises.

However, in fact, this principle does not seem to have been realised.

In the first place, it must be said that the tax legislation does not give an objective definition of business income, but rather limits itself to specifying that "business income is that which is derived from the conduct of commercial enterprises" (first paragraph, Art. 51, Decree No. 597 of 1973). Then in the following paragraphs of the same article, the legislature has specified whenever a particular activity should be defined as a commercial enterprise. Therefore, in order to characterize the *objective* ambit of the concept of "business income", it is necessary to specify the *subjective* ambit (from a tax viewpoint) of the concept of "conduct of a commercial enterprise". In fact, once the "commercial entrepreneur" is defined so as to give it meaning for tax purposes, then the extent of the concept of "business income" is determined.

First, according to the second paragraph of Art. 51, the habitual (even though not exclusive) conduct of any of the commercial activities listed in Art. 2195 of the Civil Code (industrial activities directed towards the production of goods or the rendering of services; activities connected with transportation by land, sea or air; banking or insurance activities; other activities ancillary to those mentioned above) is sufficient to constitute the conduct of a commercial enterprise even if the activity is not organised in the form of an enterprise. Therefore, it is sufficient that the activity carried on is one of those mentioned in Art. 2195 of the Civil Code even if it lacks an organisational structure of labour, employees and tangible and intangible goods which, according to the Civil Code, constitute an essential element without which no enterprise of any kind can be formed (and not only commercial enterprises).

As has already been stated, for a commercial enterprise to exist, the activities must be carried on habitually, even if not exclusively. It is, therefore, necessary that the activity be engaged in systematically and not occasionally. It is, however, not necessary that the activity be the only or the main activity of the taxpayer.

The characteristic of habitualness serves to distinguish business income from income derived from isolated speculative operations (with regard to which see Art. 76) and from occasional income (with regard to which see Art. 77) derived from an activity, which, although its objective nature is commercial, cannot amount to an enterprise because it is not undertaken habitually.

Secondly, tax legislation has extended the scope of the definition of business income, describing as commercial activities those which involve the supply of services, which, although not included amongst those activities mentioned in Art. 2195 of the Civil Code (for example, activities involving teaching, health and workshop services), are organised in the form of an enterprise or are conducted through an organisation which prepares and coordinates the means necessary for carrying out the activity (Art. 51, Decree No. 597 of 1973). However, with regard to this question, minimum utilisation of "producer goods" is insufficient (because otherwise one would reach the conclusion in almost every case that an enterprise has been formed), instead it is necessary that collaboration (which is not just occasional) by employees exists, or that the "producer goods" have a certain importance with regard to the working activity carried out by the taxpayer.

The requirement for habitualness should also be considered necessary for the activities consisting of the supply of services to third parties which are not included in Art. 2195 of the Civil Code, even though the legislature did not expressly repeat this subjective element in the 3rd pararaph of Art. 51. In fact, this requirement should be deemed to be included in the condition requiring that an enterprise should have some formal organisational structure. Finally, in no case is the existence of a profit motive necessary for the conduct of a commercial enterprise.

Thirdly, by virtue of the fourth paragraph of Art. 51, income which cannot be considered to be derived from land and buildings (because it exceeds the limits set in Art. 28 within which activities can be considered to be agricultural) also comes within the definition of business income.

Only those activities which relate to the processing, sale or transformation of products derived from agriculture, cattle raising, etc. and which are included within the normal conduct of farming operations in accordance with the governing technology and which are mainly involved with products obtained from the land or animals raised on it, as well as the activity of raising animals with feed at least 25% of which was produced on the land itself, may be considered as agricultural activities.

Since agricultural income is determined according to cadastral estimates (the so-called ordinary average income rather than actual income), the legislature wished to distinguish agricultural from commercial activity, and so adopted a criterion of prevalence in order to prevent income which is more properly classified as commercial (inasmuch as it is derived from the processing of products and raising of animals which mainly do not originate from the taxpayer's land) from being considered as agricultural. Certainly, we are dealing with a vague enough criterion which is difficult to apply, just like the rule of the "quarter", enacted with regard to the raising of animals, which cannot be described as easy to comply with because its wording is unfortunate and faulty inasmuch as it is not specified whether the ratio between feed produced on the taxpayer's land and that purchased should be calculated by reference to the quantity, the price, the nutritious value of the feed or some other criterion.

It should be noted that whenever an activity on land which exceeds the limits set by Art. 28 is carried out, that part of the income which is derived from the portion of the activity which falls within the said limits is valued on the basis of cadastral results and not actual income.

Activities relating to the exploitation of mines, quarries, salt-works, lakes, ponds and other inland waters are in every case considered to be commercial activities producing business income. In such cases the possibility of cadastral income is not available as this is ascertained only for land which is used for agricultural production.

For general and limited partnerships, the sixth paragraph of Art. 51 operates to create a presumption that the nature of every activity carried out is commercial (and that therefore all income received is business income). The foundation for this presumption can be found in the teleological nature of partnerships whose function as an institution is to permit the carrying out of the activities of a commercial enterprise in the form of a partnership. This presumption is also supported by Art. 6 of Decree No. 597 according to which the income of general and limited partnerships from all sources is considered to be business income irrespective of the partnership's objects, and is determined unitarily, according to the rules relating to this kind of income.

The same principle is valid for companies (Stock corporation – S.p.a.; Private limited company – S.r.l.; Limited partnership with shares – Sapa) which are subject to corporate income tax (IRPEG). Therefore, all the income possessed by companies should be deemed to be business income.

Business income is determined on the basis of the results shown on the profit and loss account drawn up by the entrepreneur in compliance with the rules contained in the Civil Code and according to corporate economic principles, with those variations (whether they decrease or increase income) established, for tax purposes only, by the provisions contained in the fifth chapter of the personal income tax decree (see Art. 52, Decree No. 597 of 1973). Therefore, although the starting point for the calculation of taxable income is constituted by the results shown on the profit and loss account, as a consequence of the variations which are brought about by the particular limits and valuation criteria imposed by the tax rules it is possible to note a difference between actual and taxable income.

Art. 52, although it affirms the fundamental principle according to which business income is constituted by the net profits received during the tax year and apparent from the profit and loss account, introduces the first derogations from that principle, providing that no account shall be taken of income subjected to a definitive withholding tax (these would otherwise be subject to double taxation) and losses relating to tax-exempt assets. So neither of these can be compensated for by future losses or profits respectively; they remain excluded from the calculation of total income.

Furthermore, according to Art. 52, the actual receipts and costs relating to land and buildings which are and should be registered in the land register are to be included in the accounts only if the land and buildings constitute "producer goods" of the enterprise, that is to say, they are assigned specifically to the conduct of the commercial activity. Whenever the land and buildings are not "producer goods" used in the conduct of the activity even though they are included within the ambit of the enterprise, then the income from such land and building is included in business income in an amount which is calculated by reference to the cadastral system.

In contrast with what is generally provided for other kinds of income for which the "cash" basis is in force (see Art. 9, Decree No. 597 of 1973), the elements constituting business income – profits, proceeds, expenses and costs – are taken into consideration, for the purpose of determining taxable income, according to the "earnings" basis. Therefore, these elements must relate to the conduct of the activity of the enterprise in a particular tax period, any actual collection or payment of cash being left out of consideration. This principle is specifically applied, by Art. 53 with regard to profits and by Art. 56 with regard to expenses.

However, the profits distributed by companies, cooperatives and mutual assurance associations (which have their legal or administrative seat or their principal activity within Italy) constitute the taxable income of the recipient in the period in which they are actually received in conformity with the "cash" principle, and at the same time constitute a component of business income or corporate income of the payer (see Art. 3, Law No. 904 of 16 December 1977).

Finally, the profits, proceeds, costs and expenses must have two characteristics, *certainty* and *determinability,* if they are to be calculated within the period in which they accrued. Certainty exists when the existence of the income element (active or passive) is sure since the existence of the juridical facts from which it originates has been verified. Determinability occurs when the value of the elements can be ascertained by reference to known and objective factors.

It has already been said that business income is determined on the basis of the profit and loss account.

It should furthermore be noted that this account has some formal value in that expenses and costs are not deductible, even though they were actually incurred, if they were not included in the profit and loss account attached to the tax return for the relevant year.

However, those expenses and charges which were imputable to the profit and loss account of the previous tax year and which could not be deducted then because they lacked the prerequisites of certainty and determinability are deductible in the year in which these requirements are met.

As we can see, the tax rules do not permit the entrepreneur to impute, just as he wishes in order to suit his own convenience, active and passive elements of income to different periods. This would violate the principle of the autonomy of the tax obligation; according to this principle an autonomous obligation should correspond with each tax period, and the value of this obligation is determined by the elements of income pertaining to that period.

The principles of "earnings basis", "certainty" and "determinability" should be integrated with that of *inherence",* which is laid down in the last paragraph of Art. 16. According to this, costs and expenses other than those already expressly dealt with shall be deductible if and to the extent they are incurred in the conduct of the enterprise and related to activities and transactions from which income and receipts included in business income are derived.

Some general rules about the valuation of the components of business income are laid down in Art. 75 of Decree No. 597 of 1973. So it is established that whenever a choice between different methods of valuation or accounting treatment is permitted, the taxpayer must in subsequent tax periods follow the methods already chosen. Whenever he intends to change them, he must communicate this in writing to the tax office which can oppose this, giving reasons, within 6 months. The taxpayer's communication must be made within the time within which his tax return must be filed, and shall take effect at the beginning of the next tax period.

An interesting provision is that which, being intended to satisfy the requirements of enterprises by allowing the entrepreneur some freedom of choice, authorises the tax office, at the request of the taxpayer, to adopt criteria other than those set out in Arts. 62 and 63 for the valuation of inventory and securities. This is especially noteworthy in the light of the principle (which has already been mentioned) stated in Art. 2 No. 16, Law No. 825 of 1971.

Finally, the provision introduced by Decree No. 897 of 30 December 1980 is intended to prevent tax avoidance. It states that the business income of an enterprise derived from transactions with non-residents which, through their direct or indirect relations with the enterprise, are subject to, or exercise a dominant influence on the enterprise, is computed if this would result in an increase in taxable income derived from such transactions, on the basis of the normal value of the goods transferred, services rendered, or goods or services received. This provision is also applicable when the enterprise and the non-resident are both subject to the dominant influence of the same entity.

Italy: Tax and Civil Law Aspects concerning the Annual Balance Sheet

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1. FISCAL AND CIVIL LEGISLATION CONCERNING THE ANNUAL BALANCE SHEET

Tax laws on the subject of the annual balance sheet have been issued recently and the Decrees specifically referring to this subject are:
- Decree No. 597 of 29 September 1973: Institution and regulation of income tax for individual persons;
- Decree No. 598 of 29 September 1973: Institution and regulation of income tax for corporations;
- Decree No. 600 of 29 September 1973: General regulations concerning the assessment of income tax.

The tax legislation regulates in detail the positive and negative components of the income of an enterprise and the criteria for the valuation of the assets and liabilities forming the working capital of such enterprise. This legislation does not, however, deal with the annual financial position (balance sheet and profit and loss account) and provides: "the balance sheet and the profit and loss account, apart from civil code regulations and special laws, can be drawn up under any method and in any form, provided they comply with normal accountancy technique".

Civil code norms regulate the following items of the balance sheet:
- balance sheet form: the balance sheet must be accompanied by a profit and loss account;
- determination of the positive and negative components of the annual income, and indication of the criteria of valuation of assets and liabilities in the balance sheet.

On an operational level, the relationship between civil code laws and tax laws is as follows:
(1) the balance sheet must be drawn up in compliance with civil code laws;
(2) tax law principles differing from civil code laws should be taken into account when preparing the income tax declaration and not while drawing up the balance sheet.

The income tax declaration should therefore start with the result appearing from the profit and loss account drawn up in conformity with Civil Code law. It should then state the differences (plus or minus) between the bookkeeping figures and those ascertained in compliance with the tax law. Thus, one arrives at – through their algebraic sum with the profit or loss appearing from the profit and loss account – the determination of the increase in income or the reduction of losses (or vice versa) that leads to the establishment of the total assessable income of the enterprise.

Modifications to be applied to the financial position resulting from the profit and loss account are due to causes that may:
(a) exhaust their effects in the same tax period in which they appear;
(b) result from tax considerations in previous tax periods;
(c) make their further effects felt in the following tax periods.

The category under (a) covers, for instance, costs and charges unconnected with the production of the assessable income of the enterprise, costs and burdens concerning real estate that do not represent goods instrumental for the operation of an enterprise, etc.

The categories under (b) and (c) cover, instead, those costs that must be reintegrated through allocation for depreciation, or those costs and receipts that must be transferred from one year's results to the next one (e.g. stock-in-trade held in a warehouse).

Tax laws have established the so-called *principle of continuity of balance sheets:* that is, the principle long described in the accountancy profession as "temporal unity of annual balance sheets".

The principle of the continuity of the balance sheets establishes that "if the tax office has corrected the taxpayer's valuations, the corrected figures hold good also for the next tax year".

2. ACCOUNTANCY SYSTEMS ALLOWED BY TAX LEGISLATION FOR INCOME ASSESSMENT OF ENTERPRISES

Tax legislation with respect to income of enterprises allows taxpayers to use the following accountancy systems:

(a) ordinary accountancy system;
(b) simplified accountancy system;
(c) accountancy system for particular enterprise categories;
(d) no accountancy system at all, i.e. the taxpayer is exempt from having to keep any accounting records.

The ordinary accountancy system is mandatory for all enterprises having a turnover greater than 780 million lire and requires the keeping of the following books and records: the journal, the general ledger, the balance-sheet book, the depreciation register, the warehouse book and the accounts register in code (in the case of enterprises using data-processing, electronic and similar systems in the elaboration of accounts data).

Moreover, enterprises which are obliged to withholding at source, as an advance of tax on remunerations paid to third parties, must keep the "pay-roll" and the "register" for the income from work of employees, and the "individual accounts" for each person earning income from independent work and for unearned income from investments (Art. 20, Decree No. 600 of 29 September 1973).

The simplified accountancy system is applied to private companies and to partnerships with annual returns of not over 780 million lire; this system runs from one 3-year period to another, provided the limit of 780 million lire per year is not exceeded in the last year of each 3-year period.

The simplified accountancy system consists of:
(a) separate entering in the VAT books of operations not subject to VAT registration;
(b) mentioning – within the time limit set for presenting the annual declaration – the value of stock-in-trade held in warehouses in the purchases ledger, held for VAT purposes.

The accounting requirements for special categories of small enterprises whose returns are not higher than 18 million lire annually only consist of keeping the VAT book for general entries, as the taxable income is assessed by applying to the amount of the receipts pre-set coefficients of profitability.

Exempt from the mandatory keeping of accounting records for income tax purposes are taxpayers in the special list for agriculture and fisheries with an annual turnover of not more than 10 million lire.

3. THE REQUIREMENTS FOR NEGATIVE AND POSITIVE COMPONENTS OF TAXABLE INCOME OF ENTERPRISES

The regulation of company income tax is based on Art. 2(16) of Law No. 825 of 9 October 1971, establishing that the determination of income derived from commercial enterprises must be done "in compliance with criteria of aligning the assessable income with the income calculated according to principles of economic relevance, taking into account the requirements of efficiency, strengthening and rationalization of the production unit".

On a practical level, the decrees have established that the positive and negative components of an enterprise's taxable income should comply with the following requirements:

(a) existence (or reality) of the costs and returns;
(b) inherence of costs and returns in the taxable income of the enterprise;
(c) reference of costs and returns to the tax period;
(d) charge of costs and returns to the profit and loss account;
(e) entry of costs in suitable books or ledgers;
(f) vouchers supporting costs.

The costs and returns of the taxable income of the enterprise must exist (or be real), as entering in the profit and loss account of non-existent costs is a penal offence (Law No. 516 of 7 August 1982).

The inclusion of costs and returns in the taxable income of the enterprise concerns the following aspects:

- in calculating taxable income, one does not take into account losses referring to tax-exempt sources, nor proceeds subject to withholding tax at source, nor proceeds and costs from real estate not representing goods instrumental to the operation of the company[1];
- debit interests are deductible, not for their total amount, but only for the part corresponding to returns and other items forming the enterprise's income: the part corresponding to those returns and items not forming part of the taxable income is not deductible;
- costs and charges not specifically chargeable are proportionately deductible.

Concerning the tax period to which costs and returns can be referred, this is regulated as follows: "The returns, proceeds, costs and charges all go to form part of the enterprise's income during the current financial year, unless their existence is not yet certain or their amount is not yet ascertainable in an objective way, in which case they are referred to the tax period in which said conditions occur."

1. Receipts from the real estate mentioned in the text are calculated on the basis of a rental coefficient.

The principle of assessability based on the certainty of the existence of the cost or the determination in an objective manner of such cost is, however, mitigated by the rules allowing the constitution of funds (e.g. credit devaluation fund, fund for periodical maintenance work on ships and airplanes, fund for the mathematical reserve for life insurance clients, reserve fund for premiums, reserve fund for accidents), the function of which is to distribute over a period of time costs that either probably or certainly will occur, but of which one does not know the time of occurrence or the actual amount.

The entry of costs and charges in the profit and loss account is regulated thus: "Costs and charges are not deductible if they do not appear to have been entered in the profit and loss account . . . . They are, however, deductible if entered in the profit and loss account of a previous tax period, if and as far as the deduction has been postponed in compliance with the previous articles."

The above tax regulation tends to prevent offsetting between the larger returns that may have been assessed by the Revenue while checking the accounts, and the costs not entered or entered at a lesser figure (even when the existence of the costs not entered were to be proved by certain and indisputable documents) by the enterprise when drawing up the balance sheet.

The entry of costs and charges in appropriate books and ledgers is moreover thus regulated: "Not allowed for deduction are the costs and charges of which the recording is mandatory in appropriate books for income tax purposes if their recording has been omitted or irregularly effected, except in the case of merely formal irregularities." In practice, we are dealing with the following costs and charges:

- depreciation for material or immaterial goods, including financial depreciation, which should be entered in the book of goods subject to depreciation;
- sums and amounts paid to employees, which should appear in the payroll kept in compliance with current regulations on employment;
- remuneration paid to persons working independently and investment income paid to third parties (excluding income from bonds and similar securities, or from bank and post office deposit accounts), which should be entered in special individual accounts in the name of every beneficiary.

The deductibility of costs and charges is, moreover, dependent on the existence of appropriate documentation proving their existence, their being referrable to the financial year and their inherence to the taxable income of the enterprise.

The deduction of non-documented charges is admitted exclusively, in a lump-sum form, as regards "small enterprises" and is in proportion, independently from their actual amount, to the receipts on which is based the calculation of the enterprise's income.

In the document there must be evidence that the charge has actually been met, that the cost is inherent to the enterprises' income and that it really belongs to the financial year in question.

Moreover, this document must state the general details of the persons involved in the legal relationship: "cash sums without a voucher" given as "gifts or tips" are not, for instance, costs that can be deducted from the taxable income of the enterprise.

4. TAX LAWS CONCERNING BALANCE SHEET VALUATIONS

(a) Warehouse

The valuation of raw materials and finished products can be effected on the basis of the L.I.F.O. discontinuous principle, while the valuation of products being processed should be effected on the basis of the costs incurred during the tax period.

The tax law establishes that the cost to be taken as a basis for valuation should consist of the cost of purchase or of production and directly referrable accessory expenses (e.g. transport, commission fees, duties, etc.), excluding debit interests and overheads.

In the first tax period, stock-in-trade is valued by giving to each item the value resulting from the following ratio:

$$\text{unit cost} = \frac{\text{total cost of goods produced and purchased in the tax period}}{\text{total quantity purchased and produced}}$$

At the close of following tax periods, three hypotheses are possible:

- the quantity of stock left remains unchanged;
- the quantity has increased;
- the quantity has diminished.

In the first hypothesis (unchanged quantity) warehouse stocks are valued on the basis of the same value given the items in the previous tax period.

In the second hypothesis (increased quantity) the valuation of the stocks is effected as follows:

(a) a quantity equal to that existing at the close of the previous tax period maintains the same value given to it in the past;
(b) the increase is valued by giving to every item the value resulting from the division of the total cost of the goods purchased (or produced) in the tax period by the total quantity purchased (or produced) of same goods.

For example:

– Initial stock	2,000 x 4,000 lire	8,000,000 lire
– Purchases	60,000 x 5,000 lire	300,000,000 lire
– 6,500 thus valued:		
– 2,000 x 4,000 lire		8,000,000 lire
– 4,500 x 5,000 lire		22,500,000 lire
		30,500,000 lire

In the third hypothesis (diminished quantity) it is further necessary to distinguish between the second financial year of the enterprise and financial years following it.

In the second financial year of the enterprise, the reduction of warehouse stocks is regulated in such a way as to consider "out" all quantities purchased during the year and a part of those held at the start of the year. The value to be given to the final stocks held will, therefore, be equal to the initial unit value multiplied by the quantity held at the close of the year.

For example:

– Initial stock	2,000	x 4,000 lire	
– Purchases in the year	60,000 lire		
– Sales in the year	61,000 lire		
– Financial stock held	1,000	x 4,000 lire	4,000,000 lire

In financial years following the second one, instead, one effects the valuation considering "out" the quantities purchased during the year and part of those received in previous tax periods starting with the most recent one (LIFO – "last in, first out").

For example:

- Initial stocks at 1 January 1982 of 10,000 items manufactured in the following financial years:
  1979 6,000 x 2,000 lire
  1980 3,000 x 2,500 lire
  1981 1,000 x 3,000 lire
- Final stocks at 31 December 1982 of 7,500 items: the valuation is calculated as follows:
  1979 6,000 x 2,000 lire
  1980 1,500 x 2,500 lire

The reduction of the quantities is charged to the increases formed in the previous tax periods starting from the most recent one (e.g. 1981-1980-1979).

If the weighted average unit cost of the goods, calculated with reference to the tax period, is higher than the "normal value" of the same goods in the last quarter of the same tax period, the valuation of the warehouse items can be made by multiplying the whole quantity of the goods, independently from the period the stock was built up by the normal value.

(b) Work and services performed over more than one year

Contracts referring to "work and services over more than one year" are subdivided as follows:
(a) contracts covering divisible services;
(b) contracts covering indivisible services.

Contracts under (a) refer to services that, even if performed more than once, singly or at every term, represent facts that can be independently determined and can be definitely settled independently from later services (e.g. house building, road building, etc., measured by square metre, kilogram worked, etc.).

For this type of work the amounts paid as definite settlement by the principal are included among the "returns" and the valuation of stocks left, in case of partial payment, is limited to the part not yet paid.

Contracts referring to indivisible work or services (e.g. building a factory under a turn key contract, instead, do not produce returns that can be ascribed to any single tax period, but always produce "stock-in-trade held" until the end of the contract.

The valuation of stock-in-trade held as a result of work and services over more than one year is done on the basis of:
(1) *amounts paid:* for the part of work, supplies and services covered by how far work has progressed;
(2) *amounts agreed:* for work done as per contract and not covered by how far work has progressed.

In the valuation of the "work and services being carried out" one does not take into account possible advance payments or guarantee sureties, and the price increases requested in application of regulations or contract clauses must be considered, until finally established, at not less than 50%.

Tax law provides, finally, that the valuation of the stocks mentioned can be reduced in any tax period, for contract risk at the judgement of the taxpayer, by not more than 2%.

(c) Shares and bonds

The valuation of shares, bonds and similar holdings is regulated – from a tax point of view – in a manner similar to that of stock-in-trade held in a warehouse.

Shares and other securities are also grouped into homogenous categories (shares issued by the same entity and possessing the same characteristics: ordinary shares of X Company, preference shares of Y Company and savings shares of Z Company) and valued on the basis of the LIFO (last in, first out) discontinuous principle.

Bonus shares or a free increase in the nominal value of shares owned, do not, in any case, amount to assessable income. It follows that the number of bonus shares is added to the number of shares already owned in proportion to the quality of the individual items of the corresponding category.

Also for shares and bonds tax law regulates the case in which their weighted average unit cost, calculated in reference to the tax period, is higher than the normal value of such shares and bonds. In this case, the valuation can be effected by multiplying the whole quantity of securities, independently from their purchase period, by the normal value.

The normal value of the stocks and shares should be calculated as follows:
(a) shares and bonds listed in the Stock Exchange: arithmetical average of the settlement prices in the last quarter of the tax period;
(b) shares and similar securities not listed in the Stock Exchange: one takes into account the capital losses resulting from the last balance sheet regularly approved by the issuing company compared to the last balance sheet previous to the date on which the shares were purchased, and capital reductions due to losses (Art. 2446, Civil Code);
(c) bonds and similar securities not listed in the Stock Exchange: one takes into account any fall in value that can be proved by certain and precise evidence.

(d) Allocations for pensions and welfare

Tax regulations establish that allocations concerning pensions and welfare of personnel are deductible within certain limits in compliance with the laws and regulations governing the employment contract of the individual employees.

The larger allocations necessary to re-align the pension and welfare funds with new laws and amendments (the so-called deferred compensation) may be:

- charged entirely to the financial year in which they occur;
- subdivided among not more than 3 financial years, including the year in which the amendments come into force.

In the case of subdivision over several years of longevity pay, the calculation of the amount of the single installments is left to the judgment of the company.

(e) Allocations for risks on credits

Allocations to the fund for devaluation of credits are deductible, in each tax period, within certain limits:

- 0.5% of the total amount of credits appearing in the balance sheet due to sale of goods and services (Art. 53(1), Decree No. 597 of 29 September 1973), or due, for enterprises and credit institutions, to granting credit to clients: as long as total allocation does not reach 2% of credits existing at the close of the tax period;
- 0.2% of the total amount of credits when the total allocation has reached 2% of the credits in existence at the close of the tax period and has not gone higher than 5% thereof.

When the fund has reached 5% of credits entered in the balance sheet, no further allocation is allowed.

Tax law establishes that if in one tax period the total amount of the allocation is higher than 5% of the amount of credits, the excess becomes part of the taxable income of that tax period.

(f) Depreciation of tangible goods

The depreciation of tangible goods (e.g. real estate, plans, machinery, furniture, vehicles, etc.) starts from the tax period in which the goods were or could have been utilized. For newly founded enterprises, the start of depreciation can be postponed to the first tax period in which the first returns have been received.

Tax law regulates depreciation as follows:

(a) ordinary depreciation;
(b) accelerated depreciation.

The amount of ordinary depreciation cannot be higher than that resulting from applying to the cost of the goods, including accessory costs directly charged and gross of any contributions of third parties, the rates set by the special table approved by decree of the Finance Ministry.

The depreciation rates are set for categories of homogeneous goods on the basis of the normal length of life and wear and tear in the various sectors of production.

The maximum amount of the ordinary depreciation may be exceeded in each tax period, in proportion to a more intense utilization of goods than normal, or for accelerated depreciation, in the first tax period and in the two following ones, by an amount of not more than 15% of the cost.

If the depreciation is taken for an amount between the maximum coefficient and 50% thereof, the difference can be deferred to tax periods following the normal depreciation period.

If, instead, depreciation is taken for an amount less than half of the coefficient concerned, the difference between 50% of this percentage and that applied by the enterprise (of less than 50% of the maximum coefficient) can no longer be used for depreciation in future, unless it depends on an actual lesser utilization of the goods compared to what is normal in that sector.

Moreover, tax law establishes that goods the unit cost of which is not over 50,000 lire are completely deductible in the tax period in which they have been purchased.

(g) Depreciation of intangible goods

Intangible goods (e.g. patents, trademarks, etc.) must be depreciated depending on the length of utilization set by law or contract. If the length of utilization is not ascertainable, deductible depreciation may not exceed one fifth of the cost.

The cost of good will should be written off in 5 years in equal amounts.

(h) Depreciation of costs covering more than one year

Costs covering more than one year can be divided in the following categories:

(1) costs referring to studies and research;
(2) costs of publicity;
(3) costs of creating an enterprise and long term costs incurred by newly created enterprises in tax periods previous to that in which the first returns were achieved;
(4) debit interests in the starting phase of an enterprise;
(5) cost of issuing bonds.

Costs for studies or research are deductible in the tax period in which they were incurred or in equal amounts in the same period and following ones, but not beyond the fourth one.

Tax law establishes that publicity expenses are deductible either for the entire amount in the tax period or in equal amounts in the same tax period and the two following ones.

The expenses of creating an enterprise and the costs over more than one year met by recently created enterprises in the tax periods previous to those in which the first receipts were collected are deductible in the same period and in the 4 following ones for a part not over, in each period, 50% of their total sum.

Debit interests incurred by recently created enterprises should be capitalized until the tax period previous to the one in which the first returns are received.

The deductibility of debit interests is as follows:

- one fifth of their amount in the tax period in which the first returns have been received;
- one fifth in each of the four following tax periods.

The cost connected with the issue of bonds is deductible in each tax period in an amount determined in compliance with the amortization program of the loan.

5. The revaluation of company goods and capital

In Italy, neither the legislature nor the accountancy profession has a regulated accountancy system as regards inflation (e.g. C.P.P. – Current Purchasing Power; C.C.A. – Current Cost Accounting, etc.).
The revaluation of capital can be divided in two categories

(a) economic revaluations (subject to tax);
(b) fiscal revaluations (exempt from tax).

Economic revaluations are not regulated by special laws and the revaluation value represents a positive component of an enterprise's taxable income (the so-called capital gains entered in the balance sheet).

Fiscal revaluations, instead, are regulated in detail by specific laws, and are exempt from income tax.

The main fiscal revaluations carried out in Italy have been denominated "monetary stabilization" in 1927, "monetary re-alignment" in 1936 and "monetary adjustment" in 1937; the latest regulations issued on fiscal revaluation are Law No. 74 of 11 February 1952, Law No. 576 of 2 December 1975 and Law No. 72 of 19 March 1983.

The goods that can be the object of revaluation exempt from tax are:

(1) real estate, plant, machinery and furniture;
(2) industrial patent rights, rights to utilization of intellectual property, franchising rights, trademarks;
(3) shares and interests held in subsidiary companies and associated enterprises.

The law distinguishes between the following methods of revaluation:
(1) direct (or analytical) method;
(2) indirect (or synthetic) method;

The *direct* (or analytical) *method* consists in revaluing every single item by the simultaneous increase of the value entered in the assets and of the corresponding depreciation reserve (if one is dealing with items depreciated outside the account) entered in the liabilities of the balance sheet.

The revaluation of the value entered in the assets can be done within the maximum limit given by applying to the price of cost or purchase of the item the following coefficients (Art. 2):

- 1.1 for goods purchased or produced in the financial year ending in 1981;
- 1.2 for goods purchased or produced in the financial year ending in 1980;
- 1.4 for goods purchased or produced in the financial year ending in 1979;
- 1.6 for goods purchased or produced in the financial year ending in 1978;
- 1.7 for goods purchased or produced in the financial years ending in 1977 and earlier.

The revaluation of the depreciation reserve must be done by applying the corresponding coefficients in function of the date of allocation of the individual quotas in the fund.

Example:

(1) revaluation of value of goods:

historical cost in 1979 20,000,000 x 1.4 = 28,000,000 lire

(2) revaluation of the depreciation fund:

1979	quota 10%	2,000,000 x 1.4	= 2,800,000 lire
1980	quota 10%	2,000,000 x 1.2	= 2,400,000 lire
1981	quota 10%	2,000,000 x 1.1	= 2,200,000 lire
		6,000,000	7,400,000 lire

From the above example one can see that the revaluation of the goods amounts to 8,000,000 lire and that the revaluation of the depreciation reserve amounts to 1,400,000 lire: thus, the net revaluation equals 6,600,000 lire (difference between 8,000,000 and 1,400,000), which must be entered under a specific item of the net capital.

The *indirect* (or synthetic) *method* consists in the revaluation of goods for a maximum amount in proportion to the entity of the net capital (or own capital).

The amount of revaluation that can be accomplished by the indirect method can be subdivided among the various goods for which the revaluation is allowed, at the discretion of the Board of Directors, with the only limitation being the real value of the revalued goods.

The net capital must be revalued separately depending on the year in which it was formed, with the following coefficients:

- 80% of the capital of the company or corporation given in the balance sheet of the financial year 1977;
- 60% of the increase or decrease given in the balance sheet of the financial year 1978;
- 45% of the increase or decrease given in the balance sheet of the financial year 1979;
- 30% of the increase or decrease given in the balance sheet of the financial year 1980;
- 15% of the increase or decrease given in the balance sheet of the financial year 1981.

Example:

Own capital	*Balance sheet*	*Increase*	*Decrease*	*Coeff.*	*Revaluation*
1977	1,000	1,000		0.80	800
1978	1,200	200		0.60	120
1979	1,100		100	0.45	– 45
1980	1,500	400		0.30	120
1981	1,300		200	0.15	– 30
			Revaluation		965

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Tax Treatment in Italy of International Transactions between Affiliated Companies

By Guglielmo Maisto

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INTRODUCTION

The area of international transactions is dealt with by the tax legislature in a very detailed way.

The reason for this is to be found in various factors, but in particular in the fact that the principle of worldwide taxation was only introduced through the 1973 tax reform so that the legislature and the tax authorities are actually inexperienced in the area especially in comparison with other countries.

The OECD Report on Transfer Pricing, as well as Government's recent anti-evasion policy, have, however, favored the adoption of new legal provisions and detailed administrative guidelines with respect to the tax regime applicable to intracompany transactions.

The purpose of this paper is to illustrate the system which constitutes a good pointer of the more profound interest in the tax regime applicable to cross border operations.

1. THE LAW

Art. 75(4) of Decree 597 of 29 September 1973, introduced by Art. 38 of Presidential Decree 897 of 30 December 1980, provides that "components of business income of the undertaking derived from transactions with non-residents which, either directly or indirectly, exercise a dominant influence over the undertaking or over which the undertaking itself exercises a dominant influence, are valued, if an increase in taxable income derives therefrom, on the basis of the normal value of the goods transferred, services rendered or services received. The provision is also applicable when the undertaking and the non-resident are both subject to the dominant influence of a third entity".

The new provision, Art. 75(4), clearly enlarges the scope of the transfer pricing legislation. For example, Art. 53, last para., point b. and Art. 56, last para. of Decree 597 of September 1973, repealed by Presidential Decree 897 cited above, empowered the Italian tax authorities to reallocate income on the basis of the difference between "normal values" and excessively high prices charged for goods or services only with regard to transactions made between an Italian undertaking and a foreign company which controls the undertaking directly or indirectly or which is itself controlled by a company which controls the Italian undertaking. Consequently, the arm's length rules did not apply to transactions between Italian parent companies and foreign affiliates. This exclusion, clearly in conflict with the principle of non-discrimination between resident and non-resident entities set forth in Art. 24 of the OECD Model Convention, and originally meant to favor Italian export activities, has thus now been abolished.

II. THE SUBJECTS

As indicated above, Art. 75(4) applies only to transactions where the following elements are present:

- an Italian undertaking;
- a non-resident;
- a "dominant influence" exercised by the Italian undertaking over the non-resident or vice-versa.

These three concepts are analytically dealt with in Circular 9/2267 issued by the Ministry of Finance on 22 September 1980, to which reference will be made in the following paragraphs. Despite the legislative change of 30 December 1980, the Circular substantially retains its interpretative value.

A. The Italian undertaking

The provisions of Art. 75, in terms of the enterprise to which the article applies, must be construed very broadly in line with the correlative interpretative guidelines given by the Ministry under the repealed legislation. Consequently, the term "Italian undertaking" should be deemed to include "whoever professionally carries out an economic activity organized for the manufacturing or the exchange of goods or services" (Art. 2082 of the Civil Code).

Further, in addition to the different kind of companies set up according to Italian law, the concept of "Italian undertaking" should also include individual enterprises and permanent establishments of foreign companies operating in Italy that are fiscally recognized as autonomous by Art. 19 of D.P.R. 597 of 29 September 1973. This inclusion, made clear by the "September Circular", is very significant inasmuch as it shows the tendency of the Italian tax authorities to strive for tax neutrality with regard to the legal form through which business activities are conducted.

B. The non-resident

The term "non-resident" also requires a broad interpretation (in line with the rationale of the legislation) and thus includes all corporate legal entities, whether or not recognized by Italian legislation (Anstalt, Stiftung, GIE, etc.). Further, it should be emphasized that also included in the concept of "non-resident" are foreign permanent establishments of a foreign company.

For example, a transaction effected between an Italian undertaking and a Belgian branch of a U.K. company controlling the Italian entity would fall within the scope of Art. 75(4). The rationale of this conclusion, expressly stated by the Ministerial Circular, is based on the fact that in these instances the permanent establishment acts as "a mere medium for the activities carried out by its parent company".

There may be some interpretative problems in cases where the foreign entity is a branch of an Italian company. This situation is not dealt with in the Circular as, at the time of its enactment, the legislation in force applied only to transactions between Italian controlled undertakings and foreign controlling entities. A transaction between an Italian undertaking and its foreign branch could not, on the basis of the legislation in force, fall within the scope of Art. 75.

Indeed, fiscal autonomy is recognized, to some extent, only for Italian permanent establishments of foreign companies, while foreign permanent establishments of Italian entities have never been recognized as fiscally autonomous. In this respect, it is significant to recall Ministerial Resolution 12/12/345 of 17 March 1979 in which the Ministry held that interest payments made by Italian undertakings to foreign permanent establishments of Italian companies have to be considered, for tax withholding purposes, as paid to the Italian home-office.

Another argument against the recognition, for transfer pricing purposes, of transactions effected between Italian companies and their foreign branches relies on the textual limit of Art. 75 which refers to "non-residents", a concept which cannot include foreign permanent establishments of Italian companies.

III. THE LINK OF INTERDEPENDENCE BETWEEN THE TWO ENTITIES

As in other legislation, transfer pricing rules apply only to transactions effected by entities with a link of interdependence, this latter concept being defined by Art. 75(4) of Decree 597 as "dominant influence". This definition corresponds, in substance, to the definition of "control" which, under repealed Arts. 53, last para., point b and 56, last para., was defined as the link of interdependence between the resident subject and the foreign entity.

In fact, the legislature when introducing Art. 75(4) and repealing Arts. 53 and 56 simply adapted the text of the new provision to the Ministerial interpretation regarding the link of interdependence under the repealed legislation (see Circular 42 of 12 December 1981).

The term "influence" was used in Circular 9/2267 to define "control":

> experience has given sufficient evidence that connections altering transfer prices are often represented by the influence of one enterprise on the management decisions of the other, an influence which goes far beyond the bonds of contracts or shares and which is generated by circumstances of a purely economic nature.

The concept of "control" was characterized by the Ministry of Finance as "all instances of potential or effective economic influence". The rationale of this approach is that price differentials in commercial transactions often have their fundamental foothold in the power of one party to influence strongly the will of the other party in order to effect transactions with distorted terms. Where a transaction is not negotiated between independent parties but is indicated by only one will, there is no real transaction. Thus, one party is enriched and the other impoverished, for motives which are based only on the interests of one party or one group.

Such power to weigh heavily on the will of the other party, and thus to alter the reality of transactions, can be effective without the holder of the power necessarily being a majority shareholder. Thus, the concept of dominant influence and the Ministerial approach are very suitable for the area of transfer pricing.

The economic approach followed by the Ministry is emphasized even more by the illustrative indicators which, by themselves or together with others, may give rise to the existence of "dominant influence". The indicators mentioned by the Ministry are:

(a) exclusive sale of products manufactured by the other undertaking;
(b) the inability of an undertaking to operate without the capital, products or technical cooperation provided by the other undertaking (this includes joint ventures);
(c) the right to appoint members of the Board of Directors or of the managerial staff;
(d) common members of the Board of Directors;
(e) family relationships between the parties;
(f) granting by the undertaking of supply/purchasing stations;
(g) participation of wide credit or strong prevailing financial dependence;
(h) the undertaking participation in trusts and consortia, particularly when they aim at fixing prices;
(i) control of supplies or outlets;
(j) series of contracts shaping a monopoly situation;
(k) generally speaking, all cases in which a potential or actual influence on business decisions is exerted.

The existence of only one of the indicators mentioned above does not necessarily lead to the conclusion that the dominant influence test is satisfied. In addition, the position of dominance of the entity must be characterized by a stability which renders the link strong enough to exclude a fortuitous or temporary dominance.

The above remarks show that, under Italian legislation (especially under the approach of the Italian tax authorities) the concept of the link of interdependence is very broad. It is not so broad, however, as to include the French "presumption of control" under which the mere fact that a transaction value is not at arm's length leads to the automatic conclusion that the two entities involved are interdependent.

IV. THE CRITERIA FOR EVALUATION

With regard to the determination of arm's length values, the only legislative provision regarding the matter is Art. 9 of Decree 597 of 29 September 1973, which defines the concept of "normal value" as follows:

> Normal value shall mean the price or consideration generally given for goods and services of the same or similar type, in free market conditions and at the same level of commerce, at the time and place in which the income or receipts are considered earned and the expenses and charges are considered sustained for purposes of computing income, or, if there be none, at the time and place in which the income or receipts are considered sustained for purposes of computing income, or, if there be none, at the time and place nearest thereto. In determining normal value, reference shall be made, to the extent possible, to price lists or tariffs of the enterprise which has supplied the goods and services and, if there be none, the indices and price lists of the Chamber of Commerce, professional tariffs, and stock exchange quotations, taking into account normal discounts.

On the basis of this concept, and in line with the criteria for determining the transfer price set forth in the OECD Report, the Ministry of Finance, through Circular 9/2267, indicated analytically the method to be used for each type of transaction (transfer of movable goods, transfer of technology, loans, intergroup services), all based upon the arm's length principle.

A. Tangibles

1. The comparable price method

(a) *"External" and "internal" comparison.* The arm's length rule should be applied to a transaction consisting of the sale of goods, preferably as emphasized by the Ministry (Circ. 9/2267), by using the comparable price method, i.e. the transfer value should be assessed by comparing the audited transactions with a sale which has similar characteristics and which is:

- either effected between independent parties ("external comparison"), or
- effected between a group-entity and a third independent enterprise ("internal comparison").

The latter criterion for comparison is preferred by the tax authorities. Such preference is justified by the Ministry of Finance for the following reasons:

- the unequivocal indication furnished, in this respect, by Art. 9 of Decree 597/73 allows one to conclude that "external comparison" has only secondary significance (". . . and, if there be none, the indices and price lists of the Chamber of Commerce . . .");
- the tax office would have substantial difficulties in finding objective data for price determination where the relevant market (i.e. the market in which the comparable transaction has to be found), is located abroad.

It is worth noting that the "internal price comparison" is, however, less satisfactory, as to objective results, than the "external comparison". Indeed, group sales to third parties are sometimes distorted because of the leading market position of the group to which one of the parties belongs. In other instances, group sales may be less reliable because of their rare occurrence and, consequently, they are easy instruments for "pre-determination" of normal values. It is also an ascertained phenomenon that group sales are sometimes unlikely to be found on the market because of the frequent vertical integration existing within groups of companies (controlling entity as manufacturer and affiliate as distributor or vice versa).

Despite these considerations it should, however, be emphasized that the Circular does not conflict with the OECD report, which does not express a preference for either external or internal comparison.

(b) *The relevant market.* Considering that the comparable transaction must necessarily have the same characteristics as the one to be examined by the Administration, the Circular emphasizes that "great care must be exercised in identifying the relevant market in which the comparable transaction is to be found. The reason for this is that the different locations of the buyer may justify the sale of identical products at different prices."

Further, it is stated that "as a rule the relevant market (especially for the sale of goods) must be the market of the buyer of the goods to be transferred".

(c) *The timing of the sale.* The other elements to be taken into account in order to apply the price comparison method are listed as follows by the Ministry of Finance:

- transportation;
- packaging;
- marketing;
- warranties;
- exchange rates;
- general sale conditions;
- promotional sales;
- quantity discounts;
- sales in which intangible rights are involved;
- timing of sale.

(d) *The adjustments.* The direct comparison with an arm's length transaction can be effected only if all the other characteristics of the two transactions (transportation, packaging, advertising, general terms of sale, etc.) are identical. The Ministry has, however, considered cases in which the audited transaction and the sample transaction have different elements that are easily quantifiable. In such circumstances, the two transactions can be compared after having made the necessary adjustments for the different elements.

These adjustments can be effected with reference not only to the terms of sale but also to other elements which can be quantified. This adjustment *method* is, however, not always practicable, and in all cases it must be utilized very carefully.

Indeed, merely deducting the value of the element which is different from the value of each transaction may not result in a true comparison. A case in point is where the different value relates to different packaging.

"The mere subtraction of the difference in value between the two kinds of packaging could mean that the two transactions remain dissimilar. Indeed, packaging could be an appeal to the consumer willing to pay more for the dressing of the product; or it might favour long-distance transport by prolonging the product's preservation time, allowing it to reach distant markets with smaller losses on deteriorated units."

2. The resale price method

When the comparison method cannot be applied to the transaction, provision is made for using the resale price method, whereby the normal value is equal to the price, less a gross profit margin, at which goods (purchased from a related party) are sold to an independent enterprise. The use of such a method is not advisable when the goods are processed before resale, or incorporated into more complex products, thus altering their identity. The gross profit mark-up which must be subtracted from the resale price corresponds to a percentage of the resale price, inclusive of expenses and the net profit taken by the purchaser-seller.

With regard to the determination of the profit mark-up, the Circular stipulates: "a mark-up can be calculated by considering the profit mark-up taken on comparable resales to independent parties of similar goods purchased from an unrelated enterprise by the purchase-seller under audit or, if this is not possible, one can resort to the profit mark-up taken on similar transactions by independent third parties".

In practice, the issue of determining the arm's length value is here shifted from the transaction concerning the transfer of goods to the determination of the mark-up profit margin. In this respect the Ministerial guidelines are quite helpful inasmuch as they establish the principle that the mark-up should be considered in the light of a "functional analysis" which assesses the relevant economic functions carried out in connection with the goods transacted. In some cases, indeed, the purchaser-seller undertakes functions of little economic significance (e.g. receiving or issuing invoices when the purchased goods are delivered directly by the foreign parent company to the third party).

3. The cost-plus method

As an alternative to the resale price method, the Circular indicates the possibility of determining the arm's length value by taking the production cost of the goods sold and adding to it a mark-up profit margin. In determining the costs sustained by the manufacturer the tax office can:

- make reference to the method followed by the enterprise; or
- make adjustments to the above method; or
- adopt a completely different method.

In any case, costs should include direct (e.g. raw material) and indirect (e.g. general expenses) charges, i.e. the "full production cost" should be considered.

In contrast, "standard costs" ("estimated cost of absorption of all charges based on assumed production levels and plant capacity") and "marginal costs" ("the additional costs attributable to increasing production by one unit of production ") are methods not deemed appropriate for determining the cost of production. The profit margin to be added for calculating the "normal value" (computed by multiplying the production cost by a percentage) can be determined by referring to:

- the mark-up taken by the same enterprise on sales to third parties of "similar products in the same market and involving functions equal to those of the transfer being verified";
- the mark-up obtained by independent third parties undertaking similar sales involving identical functions;
- the functions performed by the manufacturer and comparing them with those performed by independent parties. In this case the profit mark-up should be adjusted for the difference in functions being performed.

As to the choice between resale price and cost-plus methods, the Ministry of Finance (Circular 42 of 12 December 1981) emphasized the freedom of choice of the taxpayer and the tax authorities who should approach a transaction with the most appropriate criteria.

This statement follows closely the OECD Report which stresses that "there should always be the possibility, therefore, of selecting the method which provides the most cogent evidence in a particular case" (Para. 46).

4. Alternative methods

Considering that the application of the basic methods is very difficult, particularly because of the infrequency of comparable transactions, the Ministry examined the opportunity of using alternative methods of the kind referred to in the OECD Report.

The first alternative method examined by the Circular is the "allocation of overall profits" which is defined as follows: "this method involves prorating the profits arising from a sale or a series of sales, made between the two related enterprises, in proportion to the costs incurred by each". This method is not deemed advisable inasmuch as it is "potentially arbitrary" and omits consideration of market conditions. The method also disregards the principle of legal fiscal autonomy of each enterprise and complies instead with the principle of fiscal unity.

The second alternative method examined by the Circular is the "profit comparison" method which is defined as follows: "the undertaking's overall profits are compared with those of another entity operating in the same economic sector, by computing its gross profit rate, expressed as a percentage of sales or operating costs". The application of this method requires the observance of the following rules:

(a) the comparison should deal only with profits realized through the sale of goods subject to verification;
(b) if possible the comparison should be made with more than one enterprise;
(c) the comparison should also be made with profits earned by enterprises located in other countries;
(d) the comparison should be extended to more than one year;
(e) the compared undertaking should have, as far as possible, the same structure and size of the audited undertaking;
(f) the comparison should analyze in detail the single functions carried out by the enterprise (distribution, promotion, etc.).

The method of "profitability of the capital investment" ("assessing the profit earned by the enterprise, expressed as a percentage of the capital invested, and omitting any reference to production costs or to sales") is not recommended because it is subjective and arbitrary. Some useful indication may instead be given by the gross profit of the industry.

Finally, the tax authorities expressly stated that in some instances two associated companies can share the total gross receipts deriving from the sale of goods according to percentages which reflect the manufacturing and the distribution function respectively performed by the two entities. In general terms, a 2/3 - 1/3 split would be accepted.

B. Loans

As to financial transactions involving the assessment of interest rates, the Circular provides that in determining arm's length value (i.e. interest) reference should be made to the current interest applicable in the lender's country of residence (criterion of the "lender"). Indeed, in similar transactions it is the borrower in general who seeks a loan in the market of the lender and, generally, the conditions of a loan do not change with the borrower.

The above criterion should, however, be used in a very flexible manner. In some instances the lender can resort to a market other than the domestic one in order to obtain funds to be lent to the foreign associated entity. This is the case where recourse is made to the funds of subsidiaries located in low tax jurisdictions or where the sums at issue are collected in the borrower's country of residence.

Further, other factors that require consideration in determining "normal interest" include:

- the amount of the loan;
- the term of the loan;
- the currency in which it is made;
- any guarantees in respect of the loan.

C. Intangibles

Transactions concerning the use of intangibles can also be valued according to the basic methods based upon the free market price. This is the case where the goods transferred have been subjected to a previous transfer to an independent enterprise. The same (application of one of the basic methods) applies where an Italian subsidiary, acting as licensee of the foreign parent company, grants for consideration a sub-license right to an independent company.

As is clarified by the Circular, "the royalties paid by the sub-licensee, less costs and a profit mark-up, will enable the assessment of the 'normal value' of the royalties agreed upon by the foreign corporation owning the intangible asset and the Italian subsidiary". Disregarding the three basic methods which will rarely be applicable in transactions, with intangibles, the Circular focuses on useful parameters, worked out by enterprises operating in the transfer of technology sector, which may help to find the normal value of this kind of transaction.

Indeed, in determining what the royalty shall be, the licensor aims to secure costs incurred plus an adequate profit, this latter element depending upon the licensee's exploitation capabilities and production costs. Thus, the licensee's forecast profit and loss statement will give a profit estimate on which the royalty percentage is applied.

The factors which influence such determinations are identified in the Circular as:

a. research and experiments to be carried out;
b. obsolescence (it will occur in less than or more than a year);
c. the technical life of the industrial invention;
d. originality, complexity and technological importance;
e. results obtained by the licensor himself from exploitation of the industrial invention.

The above factors should, then, be combined with elements of a legal nature which in licensing agreements limit or enlarge the rights and benefits to the licensee and which consequently have an influence on royalty value.

The tax office will therefore have to check the underlying royalty agreement and determine which of the following elements exists:

a. exclusive rights;
b. territorial limits;
c. protection granted to the industrial invention by the laws of the country where the licensee has his residence;

d. prohibition of the exportation of products derived from the industrial invention's use;
e. limitations in the production of products derived from the industrial invention's use;
f. right to grant sub-licenses;
g. contract duration;
h. limitations on size or on other features of the products manufactured using the industrial invention;
i. right of exploiting discoveries or developments of the invention;
j. fixing of the products' resale price;
k. preferential rights with respect to third parties.

Obviously, in addition to the above requirements, or alternatively, fairness of compensation paid may be inferred from other circumstances, such as:

- comparison of fees paid to the associated licensor with fees paid by independent undertakings to it for the same intangibles used by the associated licensee;
- comparison of fees paid by the associated licensee, with royalty rates generally provided for in similar contracts in the technological area concerned;
- acceptance of "fairness" by the tax authorities of other countries of royalty fees paid by the licensor's affiliated companies for the exploitation of the same or similar intangible rights.

Considering the fact that it is difficult to establish criteria for determining the normal value of transactions involving intangibles and keeping in mind the taxpayer's need for certainty, the Circular has fixed predetermined "normal values" acceptable in principle as to their fairness.

Specifically the Circular provides that:

- royalties up to 2% of sales will be allowed when the transaction is governed by a written contract entered into before the first payment and where sufficient documentary evidence can be given about the effective use of the license;
- royalties ranging from 2 to 5% will be considered fair under more onerous conditions, i.e. where the taxpayer can justify the higher rate by showing "technical" data, originality, results obtained, etc.;
- royalties exceeding 5% of sales (or royalties of any amount paid to low-tax jurisdictions) will be allowed only "in exceptional cases" that are justified by the high technological level of the industry or by other circumstances.

D. Intragroup services

According to the Circular, the frequent atypicality of the services rendered between affiliated companies requires, even before assessing the "normal value", the verification of the degree of utility of the service received by the Italian entity in order to evaluate the deductibility of the relevant cost. In practice, the Ministry adopts a principle established in the OECD Report.

The range of services rendered within a group of enterprises is strictly inherent to the corporate multinational structure and reflects the coordination activity of the parent company, which aims at insuring the effectiveness of its control over its subsidiaries. In these instances the receiving entity is really provided with no benefit and therefore relevant compensation paid should be deemed to be non-deductible.

In order to illustrate the concept of "shareholder function" (i.e. no benefit for the subsidiary), the Circular gives the example of the elimination of a defect in the subsidiary's production system through the exercise, by the parent company, of a "control" function. The advantage occasionally received by the affiliated entity does not justify the tax deductibility of compensation for the shareholder's function exercised by the controlling company.

The apportionment of charges pertaining to a service rendered within a group thus requires the combination of two factors: the "advantage" received by the beneficiary and the "function" performed by the supplier. As to the determination of "normal value" the Ministry makes it clear that the "basic methods" can hardly be utilized and that different rules should be adopted, such as:

- the criterion used for determining compensation must be established; arbitrary determination would certainly be unreliable;
- normal value could be based on the cost sustained by the performing entity during the contract duration and the consideration might be computed as a percentage of the gross income obtainable by the beneficiary;
- the time needed to accomplish the service, its regularity, risk of losses, etc. should be considered.

E. Cost-sharing arrangements

On the specific subject of cost-sharing arrangements, the same Circular provided a very broad definition: "agreements drawn up by various group entities located in different countries, according to which costs relevant to . . . services available within the group are allocated to the various associated entities in relation to the benefits which each can derive from their utilization". Among the services listed by the Circular are technical, administrative, marketing and accounting assistance, research and development, etc.

It follows that payments for the above services should, in principle, be recognized as deductible from the payer's taxable income. In this respect it is worth emphasizing that the Ministerial approach follows two previous Resolutions (No. 977 of 8 February 1977 and No. 9/258 of 24 January 1979) in which the tax authorities recognized the tax deductibility of payments made under cost-sharing arrangements.

The compensation (participation share) provided in a cost-sharing arrangement, and determined on the basis of a special formula, is recognised by the Circular which gives, as an example of a formula, the ratio between the turnover of the group and the turnover of the beneficiary entity. As an alternative to turnover, the capital, the number of employees, the production capacity may be used. The documentary support relevant to the service performed and to the allocation formula is a crucial element for recognition, by the tax authority, of the arrangement effected.

[Continued on p. 435]

Foreign Tax Credit in the Italian Tax System

By Gian Carlo Croxatto

1. GENERAL

One of the major features of the Italian tax reform, regulated in its basic principles by the Law of 9 October 1971, was the abolition of the schedular income tax system and the introduction of two new personal taxes on income of individual persons and of corporations.

The preceding system of "real" taxes, based on the principle of territoriality, was therefore replaced by new taxes to which foreign income derived abroad by residents in Italy was also taxable.

Under the new system Italy asserts jurisdiction to tax on the basis of two factors: residence and source of income. Thus if a non-resident individual or corporation derives Italian-source income, that income is subject to the Italian income tax only because of its source. On the other hand, if an Italian resident derives income abroad, that income is subject to the Italian tax because of the residence of the taxpayer in Italy.

When income is derived from sources outside Italy it will also usually be taxed in the countries where it was derived. It has, therefore, been necessary to introduce unilateral measures to prevent international double taxation.

The primary device provided for in the Italian tax system is a credit for foreign taxes on income from sources abroad.[1]

Since its inception the foreign tax credit has been regulated by Art. 18 of Decree No. 597 of 29 September 1973 and by Art. 9 of Decree No. 598 of 29 September 1973.

The provisions of the Italian legislation on the foreign tax credit have, however, been considerably changed by Decree No. 897 of 30 December 1980, which substantially increased the amount of credit that may be obtained.

The Italian legislation also provides for application of the exemption method on 60% of the dividends distributed by a controlled foreign subsidiary to its parent company in Italy (unilateral system of intercorporate dividend relief provided for by Art. 6 of Law No. 904 of 16 December 1977).

There is no option to choose between the exemption and the foreign tax credit method.

No deduction of foreign income tax is allowed from the domestic tax base.

2. FOREIGN-SOURCE INCOME TAX

Regarding the identification of the foreign taxes which are creditable the following remarks are to be made.

The Italian legislation grants resident taxpayers the right to a tax credit in respect of taxes definitively paid abroad on income derived there. The tax credit is allowed only for taxes paid abroad on foreign-source income, which is included in the taxpayer's Italian tax base. Therefore, no tax credit is allowed for foreign taxes on income *exempted* from Italian taxes. For instance, the credit is not granted for taxes withheld at source on 60% of the dividends distributed by a foreign subsidiary to its parent company in Italy, since this part of the dividends is not taxable in Italy.

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In daily life Mr. Croxatto is a tax consultant who is admitted as an advocate to the Bar of Genoa.

He holds a number of important positions with national and international organizations: he is a member of the Board of ANTI (the national association of tax consultants), the Italian Branch of IFA and the Confédération Fiscale Européenne (of which he also is a member of its Fiscal Committee). Furthermore, he is a member of the International Bar Association and a member of the Fiscal Committee of the International Chamber of Commerce (Italian branch). He is also a member of the board of auditors' committees of several corporations.

Mr. Croxatto is the author of numerous publications on taxation, with particular reference to the taxation of business income and international tax problems.

1. Some general articles on foreign tax credit under Italian income tax law are:
- Napolitano, "Credito d'imposta per i tributi pagati a Stati esteri", *Consulenza* (1978), No. 20, p.41.
- Saviano, "Credito d'imposta per i redditi prodotti all'estero", *Tributi* (1979), p.47.
- Mayr, "Il credito per le imposte pagate all'estero", in *Il Corriere tributario* (1979), p.435.
- Croxatto, "Il credito di imposta per i redditi prodotti all'estero, relazione all'VIII Convegno della Società per lo studio dei problemi fiscali", Rapallo, 29 giugno 1979.
- Fantozzi, "Credito di imposta per i redditi prodotti all'estero", *Guida fiscale italiana* (1980), p.333.
- Betti, "Il credito per le imposte pagate all'estero", *Il Corriere tributario* (1981), p.840.
- Menti, "Il credito d'imposta per i redditi prodotti all'estero dopo il DPR 30.12.1980, n.897", *Bollettino tributario d'informazioni* (1981), p.746.

The tax credit is granted only for taxes paid on foreign-source income. It should be noted that in the Italian legislation no definition of "foreign-source income" is given, since it only states what is to be considered income from Italian sources for purposes of taxation of non-resident individuals or corporations.

Furthermore, there is no definition in the Italian legislation of the term "foreign income tax" nor is there a list of foreign creditable taxes. In this respect, it is interesting to report the change of opinion of the Italian tax administration concerning the tax applied in Algeria to foreign enterprises carrying on temporary activities in that country under a contract for public works. The tax, which is calculated at a fixed rate on the total price of the contract, was initially[2] considered a foreign income tax creditable against Italian individual or corporate income tax. Since this tax was not considered an *income tax* it was then deductible as an expense from the tax base of the Italian taxes. Recently the tax administration changed its view and considered the Algerian tax a foreign income tax creditable against Italian income taxes.[3]

For purposes of the tax credit, only foreign taxes on income *definitively paid* to a foreign country are creditable. The tax administration has recently clarified[4] that a tax is definitively paid when no partial or total reimbursement may be obtained. It is therefore not necessary that the foreign income be definitively assessed, as the tax administration previously seemed to think.[5]

3. LIMITATIONS

With reference to the limitations on the amount of credit, it is first of all to be noted that the foreign tax credit is granted with the same limitation with which the foreign country, that has applied the taxes to be credited, allows a tax credit or an exemption to income of the same nature produced in Italy (reciprocity clause).

This reciprocity requirement is not only provided for resident aliens, but also for resident Italian citizens.

Where the foreign country does not allow a tax credit or an exemption for income produced in Italy the tax credit is granted only up to an amount equal to 90% of the proportion of the Italian tax allocable to business profits and up to an amount equal to 50% for all other categories of income.

In both cases the amount of the foreign tax credit is allowed up to the amount of the Italian tax which would be applicable if the income were derived from Italian sources. This limitation applies to each foreign country separately (per country limitation).

The per country limitation is computed by multiplying the Italian tax (before credit) against which the credit is claimed by a fraction, the numerator of which is taxable income from sources within the foreign country and the denominator of which is total taxable income from all sources, both foreign and national.

An overall limitation on the tax credit is not provided and therefore there is no option for the taxpayer to choose between the overall or the per country limitation.

In the case of an excess of foreign tax, no carry-back or carry-over is possible. Therefore the amount by which creditable taxes of a foreign country in a given year exceed the amount of the allowed foreign tax credit in that year may not be carried back or forward. Nor can the non-creditable balance of foreign taxes be deducted as an expense against profits.

4. INVESTMENT INCOME

With respect to credit for foreign taxes on investment income, it is to be noted that foreign taxes applied at source on such investment income (dividends, interest, royalties) are creditable against the income tax of the Italian resident recipient under the above rules.

It is to be pointed out that where the reciprocity clause is not fulfilled because the foreign country does not allow a tax credit or an exemption for income produced in Italy, the tax credit for investment income is granted only to a maximum of 50% of the Italian tax which would be applicable if the income were produced in Italy. In fact, as mentioned above, where there is no reciprocity the tax credit is allowed to a maximum of 90% of allocable Italian income tax for business profits and 50% for all other categories of income.

All income received by a corporation is deemed to be business income. Therefore, if there is no reciprocity, a tax credit is also allowed to a maximum of 90% of allocable Italian income tax also where a corporation or a partnership receives dividends, interest or royalties, on which taxes at source were imposed, from a non-treaty country.

5. FOREIGN SUBSIDIARY

No foreign tax credit is granted for taxes paid abroad on income there derived by a foreign subsidiary of an Italian corporation. Note that under Italian tax law it is not possible for a domestic corporation with foreign subsidiaries to be taxed on the basis of a consolidated return. In no circumstance may a foreign subsidiary's profit be attributed to its Italian parent corporation.

Therefore income or loss incurred abroad by a foreign subsidiary is not taken into account in the computation of taxable income of the Italian parent corporation before it is distributed to the Italian company.

Foreign taxes imposed on income of foreign subsidiaries are not creditable against the Italian income tax of their Italian parent company. No foreign indirect tax credit is provided by the Italian legislation.

The foreign subsidiary is considered an independent tax subject, and if it does not distribute any dividend, its Italian parent company does not earn any income abroad.

2. See Ministerial Ruling No. 9/416 of 12 March 1979.
3. See Ministerial Ruling No. 9/2540 of 21 April 1983. As regards this ruling, see: Betti, Ianni Alice, "Sul credito per le imposte pagate all'estero il Ministero cambia rotta", *Il Corriere tributario*, (1983), p.904.
4. See Ministerial Ruling No. 3/7360 of 8 February 1980.
5. See Ministerial Ruling No. 7/1496 of 30 April 1977.

No foreign tax credit is then granted in Italy.

With respect to the case in which the foreign subsidiary distributes its profits to its Italian shareholder it is to be noted that the imputation system (introduced in the Italian tax system in 1977) does not apply to a distribution from non-resident companies. However, in order to reduce the burden of Italian taxes on foreign dividends, privileged tax treatment has been provided. In fact, only 40% of the total amount of the dividends received from foreign related corporations is subject to the Italian income tax. For this purpose, foreign controlled corporations are defined as foreign companies in which another company owns at least 10% of the capital (5% in the case of companies listed in a Stock Exchange).

A foreign tax credit is granted only with regard to taxes withheld at source on 40% of the dividends distributed. The remaining part of the withholding taxes is not creditable since the corresponding percentage of the dividends is not taxable in Italy. That non-creditable balance of foreign taxes is not even deductible as an expense against profits, since an income tax is in no circumstance deductible.

6. FOREIGN PERMANENT ESTABLISHMENT

With respect to a credit for foreign taxes on foreign-source income derived by an Italian enterprise operating directly abroad or through a permanent establishment, it is to be noted that such income (whether the enterprise is carried on by an individual or by a corporation) is a part of its total taxable income in Italy.

The foreign tax credit is then granted to the Italian enterprise for the taxes paid abroad on such income, under the above-mentioned basic rules and with the same limitations.

7. TAX SPARING

No special provisions, such as "tax sparing", are contained in the Italian tax legislation with regard to foreign tax credits in the relations with developing countries.

Therefore, if a foreign country gives an incentive to encourage investments from abroad, the amount of the foreign tax waived or reduced may not be credited against the Italian tax, since only taxes that have actually been paid are creditable.

A general tax sparing clause has been included, for instance, in the double treaty between Italy and Trinidad-Tobago. A tax sparing clause regarding only dividends, interest and royalties is provided in the treaty between Italy and Singapore.

8. DOMESTIC PERMANENT ESTABLISHMENT

No foreign tax credit is granted to a permanent establishment in Italy of a foreign company.

A foreign enterprise (carried on by an individual or by a corporation) operating in Italy through a permanent establishment is taxed in Italy only on income earned in the country. Therefore where a permanent establishment in Italy of a foreign company receives from abroad items of income, having borne foreign taxes, no Italian taxes are applied on such income. Since in such a case foreign income is not taxable in Italy, no unilateral provision to prevent double taxation is provided in the Italian legislation.

9. ADMINISTRATIVE REQUIREMENTS

As regards the administrative requirements for claiming the foreign tax credit, the following rules exist.

The credit must be claimed in the tax return relating to the year in which the foreign taxes are definitively paid, otherwise the right is lost. If the tax due in Italy for the year in which the foreign-source income was included in the taxable base has already been settled, a new settlement shall take place. The new settlement also has to take into account any increase in foreign-source income as compared with foreign income declared. The tax credit shall be applied to the annual return in which it was claimed. If the term within which the assessment has to be carried on has already expired, the credit shall be limited to that part of the foreign tax proportional to the part of foreign-source income subject to taxation in Italy. If the credit is greater than the amount of tax determined for the year in which the credit is allowable, the taxpayer is entitled to a refund of the excess.

Taxation of Capital Gains realized by Non-residents on the Sale of Interests in Italian Corporations

By Siegfried Mayr

Dr. Mayr obtained a degree in Economics and Commerce from the University of Padua and a Law degree from the University of Milan. He was a guest professor at the University of Hamburg (Federal Republic of Germany) in Italian tax law. He is currently lecturing on the same subject as a guest professor at the University of Innsbruck (Austria) and is also a professor in tax law at a postgraduate institute in Milan.

Dr. Mayr started his career as a tax manager with the Milan branch of a major U.S. audit firm and is now a tax consultant in the same city.

He has written numerous articles on taxation in Italian and foreign tax journals and has spoken at seminars and conferences in Austria, Canada, Germany, Italy and Switzerland. He was the national reporter for Italy at the 1981 IFA Congress in Berlin and participated in the seminar on the imputation system at the 1982 IFA Congress in Montreal.

His publications include:
- The Swiss–Italian Double Taxation Treaty (Cosmos S.A., Berne, Switzerland);
- Taxation of Companies in Italy (Bundesstelle für Aussenhandels-Information, Cologne, Federal Republic of Germany).

Law No. 897 of December 1980, which became effective as of 1 January 1981, introduced a new category of income in respect of which non-residents are taxable. Art. 19(10) of the Italian Tax Law, which contains a list of the various types of income for which both individual and corporate non-residents are taxable in Italy, has been amended to include capital gains realized from the sale of shares or other interests[1] in an Italian corporation, or shares listed on the stock exchange through which the transferor exercised or could have exercised control over the company ("dominant influence") within the meaning of Art. 2359(1)(2) of the Italian Civil Code.

"Dominant influence" is defined in the above-mentioned Art. 2359(1)(2) as control exercised over the company by means of shareholdings or other interests (quotas) or by means of special agreements with the same company.

The scope of this new provision has been debated since its entry into force. Articles on the subject published in the tax journals[2] show varying opinions as to the basis of taxation of such capital gains. Some authors maintain that the sale of shares in an Italian company, if made by a foreign entity which carries on a commercial activity – as in the case of a commercial entity resident in Italy – would not qualify as a "capital gain" but would constitute an element of gross income of the business income of the foreign company. If so determined, the gain on the sale of shares would not be subject to taxation in Italy since business income is taxable in Italy only if the activity is carried on through a permanent establishment in Italy. Other authors limit the characterization of the gain as business income to the case of a foreign finance company (holding company) and maintain, furthermore, that taxation in Italy would in any case be subordinated to the presence of a speculative intent, as defined by Art. 76 of the Tax Law.

Therefore, major questions remain regarding the practical effect of this new provision. The questions refer not only to the conditions under which liability for the tax arises but also to the method of computation of such capital gains. An official interpretation is expected from the Ministry of Finance which, until now, has expressed no opinion on this subject. However, it is certain that the new law introduced, in addition to those already contained in Art. 19, a new category of income in respect of which non-residents are taxable where the elements prescribed by this law are present. These elements are as follows:

(1) Sale of interests ("quotas") or unlisted shares of an Italian corporation. In this case, the capital gain is taxable regardless of the amount of the holding in the Italian company.

(2) If the shares are listed on the stock exchange, the capital gain is taxable only if the transferor exercised or could have exercised control over the company through those shares within the meaning of Art. 2359(1)(2) of the Italian Civil Code. The control defined there is that which is exercised by means of the shares or interests (quotas) or by means of special agreements with the company.

1. *Editor's note:* "quotas" are shares in a limited liability company (società a responsabilità limitata).

2. Antonini, E., "Quel pasticciaccio delle plusvalenze", *Il Sole 24 Ore,* 6 January 1981; Carbonetti, F., "Plusvalenze realizzate da non residenti su quote o azioni di società italiane", *Diritto e Pratica Tributaria,* Part I (Cedam, 1981), p. 390; Corsaro, C., "Le plusvalenze realizzate da non residenti mediante cessione di quote o di azioni di società di capitali residenti", *Il Bollettino Tributario d'informazione* (1981), p. 567; Mayr, S., "Plusvalenze da cessione di partecipazioni in società di capitali italiane", *Atti del Convegno dell'Unione Nationale Giovani Dottori Commercialisti,* Venezia, 18-19 marzo 1982; Moroni, S., "Plusvalenze: un articolo chiacchierato", *Il Sole 24 Ore,* 24 Januari 1981; Pansieri, S., "Le nuove fattispecie di territorialità delle plusvalenze realizzate da non residenti", *Diritto e Pratica Tributaria,* Part I (Cedam, 1981), p. 1097; Tremonti, G., "Quelle plusvalenze tra fantasia e realtà", *Il Sole 24 Ore,* 7 January 1981.

The condition of control is therefore required only in the case of listed shares; in the case of shares not listed, control, i.e. the size of the holding, is not relevant. The legal provisions in question do not apply to the capital gain realized from the sale of an interest in an Italian partnership.

As previously mentioned, within the profession opinions vary as to the basis of taxation. Basically, these opinions are based on the following interpretation: the legal provisions defining "business income" (Arts. 51 through 54 of the Tax Law) state that the gain from sale of shares, bonds and similar securities shall be regarded as revenue (gross business income) when such exchange constitutes part of the activity of the enterprise whose specific, although not exclusive, purpose is the assumption of shareholdings in companies and entities or the purchase, sale or possession or management of public or private securities. Thus, the consideration received for a transfer of shares – as in the case of the transfer of goods whose production or sale is part of the enterprise's activity – forms part of a firm's gross income (revenue) and is not an element for determining a capital gain. Only assets other than those indicated in Art. 53 (which refers to goods and also to shares) can lead to a capital gain. This principle is valid, in any case, for partnerships and for corporations.

Some of the professional opinions apply this principle, valid for resident companies, also to foreign companies with the following consequence: if the foreign company (transferor of the shares of the Italian corporation) meets the requirements indicated by Art. 53, the consideration received for transfer of the shares constitutes gross revenue which, with respect to non-resident enterprises, can be taxed in Italy only if derived from a business activity carried out in Italy through a permanent establishment.

As indicated above, the Ministry has not yet expressed an official opinion on this issue. The author's opinion is, however, the following:

Pursuant to the amendment of Art. 19, the legislature (through Law No. 897) introduced a new, autonomous category of income for which non-residents are liable to tax. The new taxable income refers to the capital gain realized through the sale of shares or interests (quotas) of Italian corporations. The concept of capital gain is defined by other provisions of the Tax Law. There is no doubt that this type of income represents an autonomous category of income (and therefore different from that defined as business income realized through a permanent establishment) which is sufficiently defined with respect to all relevant elements in order to create a basis for taxation if the conditions of the article are met. Due to the principle of "isolated treatment" of the various types of income – listed in Art. 19 of the Tax Law – in the taxation of non-residents, certain rules, valid in the determination of taxable business income for resident enterprises, cannot be applied to non-resident enterprises. Therefore, if a non-resident company realizes a difference between the price received and the cost on the sale of an interest in an Italian corporation, this difference is qualified by the new law as a capital gain. Thus, the consideration does not represent an element of gross business income (which would be taxable only in the case of a permanent establishment) but represents an element for the determination of a capital gain. This is so regardless of whether or not one of the main objects of the foreign transferor's enterprise is the purchase and sale of shares. In my opinion, liability for tax always arises when the conditions of the new legal provision are met, irrespective of the activities of the foreign transferor or of its legal form and regardless of whether it has a permanent establishment in Italy. It is true that this opinion leads to a discrimination between residents and non-resident individuals. Resident individuals who hold the interest privately (i.e. not in the course of business) are taxable on the capital gain realized through the sale of shares only if the transaction is undertaken for a speculative purpose (Art. 76 of the Tax Law). One can conclude, however, that for non-resident individuals the taxation also arises only in the case of a transfer with a speculative purpose.

With respect to the method of taxation, the capital gain in question is taxed as ordinary taxable income, i.e. subject to the Italian income taxes: corporate tax and local income tax (total tax burden in 1983 of 41.34%) if the foreign transferor is a corporation, a partnership or other entity; individual income tax (at progressive rates) and the local income tax (normal rate 15%; 16.2% in 1983) if the foreign transferor is an individual. The tax must be paid on the basis of a tax return. No withholding taxes apply.

The taxation of such capital gains under the Italian Internal Revenue Law may be excluded by the double taxation treaty between Italy and the country of residence of the foreign transferor. This new type of income under the Italian law would be classified, under the treaties, either as income from a "capital gain" or as "other income" ("income not expressly mentioned"). Generally, the taxation of said categories of income is attributed by the treaties to the country of residence of the transferor (if the capital gain is not related to property forming part of the business activity of a permanent establishment in the other State).

The Italy-U.S. treaty, however, contains no provision with respect to income from "capital gains" or to "other income". Therefore, the Italian Internal Revenue Law on the taxation of the capital gains in question is not affected by treaty provisions where the transferor of the shares is resident in the United States. This capital gain will probably be covered by the new treaty between Italy and the United States.

Taxation of Interest and Dividends in Italy

By Augusto Fantozzi

Augusto Fantozzi was born in Rome in 1940, and is married with two daughters. He graduated in Rome and became Ordinary Professor of Tax Law, first at the University of Perugia and then, in 1974, at the University of Rome.
He is senior partner of the Fantozzi-Biscozzi tax firm, with offices in Rome and Milan, specializing in corporation tax law and in international taxation.
Mr. Fantozzi is also the author of various publications on Italian tax law. He is secretary of the Italian branch of IFA and recently became Vice-President of the Ministry of Finance Superior Council.
He has attended several international congresses on tax matters and has been a speaker at many of them.
He is fluent in German, French and English.

Before entering into the details about the taxation of interest and dividends in Italy, it might be beneficial to give a brief outline of the structure of the Italian tax system.

The Italian tax system is based on two general income taxes, *imposta sul reddito delle persone giuridiche* (IRPEG) due by corporate taxpayers and *imposta sul reddito delle persone fisiche* (IRPEF) due by individuals.

Resident taxpayers (both corporate and individuals) are subject to these general income taxes on their world-wide income, and credit for foreign taxes paid abroad on foreign income is allowed on a per-country basis.

Non-resident taxpayers are subject to general income taxes only on Italian-source income (territoriality principle) according to the following principles: business income produced in Italy by non-residents is taxed only if derived through a permanent establishment located in Italy and on the basis of book income (plus and/or minus tax adjustment) upon filing the annual tax return, while other types of income, like interest income, royalties and dividends, are often taxed at source at a flat rate.

The corporate income tax (IRPEG) is levied at the rate of 30%, while the individual income tax (IRPEF) is due at progressive rates ranging from 18% up to 65% for taxable income exceeding 550 million lire (about $450,000).

In addition to the above two taxes a third tax is due on domestic income: the *imposta locale sui redditi* (ILOR) is a local tax levied at a 15% rate by the central Government on behalf of local entities. Certain types of income, such as dividends received and employment income, are not subject to the local tax.

A 5-year loss carry-forward is allowed both to resident and non-resident corporate taxpayers only for IRPEG purposes, and exclusively with respect to business income.

PART I – INTEREST PAYABLE

1. Deductibility of interest paid

Interest payable is deductible only if inherent to trade or business income (hereinafter called business income). Interest paid by companies (whether incorporated or not) is generally deemed connected with their business and is, therefore, in principle deductible for tax purposes.

Interest not connected with a trade or business paid by individuals is generally non-deductible except for mortgage interest for which a tax deduction is allowed up to a maximum of 4,000,000 lire per annum (about US$3,500).

Interest payable is equally deductible whether paid to resident or non-resident recipients.

As mentioned above, interest payable is generally tax deductible when inherent to business income. Nevertheless, taxpayers reporting business income including exempt income or income finally taxed at source cannot deduct 100% of interest payable since such interest is deemed proportionally connected with all categories of taxpayers' income. In fact, according to Art. 58 of Decree 597, interest paid shall be deductible in an amount corresponding to the ratio between the amount of gross receipts and other income included in business income and the total amount of all income and receipts, including exempt income.

Another limitation to the deduction of interest payable is provided in the same Art. 58 and applies to interest to be capitalized to fixed assets: according to this rule, interest paid on loans entered into for the purchase of or construction of fixed assets to be used in the business increases the cost of the assets in the tax period prior to that in which the assets begin or could begin to be used. The cost of fixed assets so increased by capitalized interest is the basis for computation of annual depreciation allowances.

The Italian Government has never enacted any provision concerning the ratio of borrowed capital to equity capital in the case of legal entities. Only for foreign exchange purposes (Art. 4 of Law 43 of 7 February 1956) does the law state that fully owned subsidiaries or branches of foreign companies cannot borrow money from domestic sources or issue bonds in excess of 50% of the paid-in capital or capital supplied by the parent company, respectively. However, the non-observance of this rule does not imply any penalty and may only lead to the loss of certain benefits (allowed only for investments in manufacturing activities).

The Italian tax law does not provide any upper limit as far as the interest rate is concerned. In any case, as a general rule, all business transactions, and intercompany transactions in particular, must respect the arm's length principle, and amounts of royalties, interest, purchase prices of imported and exported goods can be adjusted by the tax authorities if deemed a vehicle for the transfer of profits abroad.

It is to be noted, however, that, at present, interest on international loans (whether intercompany loans or not) cannot be questioned by the Italian tax authorities. Foreign exchange regulations provide, in fact, that with respect to incoming and outgoing loans residents of Italy cannot conclude agreements before they have obtained formal consent of the competent foreign exchange authorities, to whom a special application must be made. Such an application must specify the amount of money to be lent or borrowed, the indication of the contracting parties, the currency in which repayment is to be made, the date of repayment, the interest rate, and any clause which might result in extra payments or costs to the resident of Italy. Should the conditions be found not at arm's length, or excessively onerous, or risky with respect to fair market conditions, the approval is withheld.

To ensure the respect of such rules, the law prescribes that all transactions with foreign residents are to be accomplished with the assistance of specially authorized banks (banche agenti) which are required to check whether the person in question has obtained the consent of the foreign exchange authorities and whether the contract meets the required conditions. Direct payments from the resident debtor to the foreign creditor and vice versa are deemed to be criminal offenses.

While the Italian tax law does not provide any upper limit to the interest rate there is a special provision of the law (Art. 43, Decree 597) concerning interest-free loans or loans granted at too low rates.

As a general principle, the right to interest on capital lent can be presumed by the tax authorities to be an amount not in excess of 5%, even if the documents do not show any interest nor show it to have been agreed at a lesser amount. Such provision equally applies to resident and non-resident parties, whether individual or corporate and whether independent or not. This provision, of course, does not apply if the loans have been agreed with the prior consent of the Italian foreign exchange authorities.

2. Levying taxes on interest payments

As already mentioned, the Italian tax system provides for the application of the so-called world-wide principle of taxation of resident taxpayers, while non-residents are subject to taxes exclusively on the basis of income produced in Italy. Art. 19 of the above-mentioned Decree 597, dealing with the application of the taxation of non-residents, expressly considers the "income from capital paid by the State, by parties resident within the territory of the State or by permanent establishments of non-resident parties set up within the said territory" as produced in Italy (and consequently taxable in Italy). It can therefore be concluded that interest paid by a resident to a non-resident party is always taxable in Italy.

Just for completeness it can be stated that interest paid by a resident to another resident is also always taxable with the sole exception of public bonds and other similar debentures.

Corporate taxpayers, partnerships, sole proprietors, and other entities required by the law to act as withholding agents are obliged to withhold the tax at source when paying interest to non-resident recipients. Individuals not engaged in a trade or business are not required to act as withholding agents. Since various kinds of interest payable abroad are subject to a final tax at source, this may result in tax evasion.

Interest due by banks to any person, interest payable on private bonds, *and generally speaking all interest due by enterprises* (whether run by individuals, partnerships or corporations) are subject to withholding of tax at source. Interest due by an enterprise to another resident enterprise (being in principle includable in the recipient's taxable income) is exempt from withholding at source while remaining taxable income for the recipient.

The withholding operated at source is in principle a final tax if the interest recipient is a non-resident or if he is an individual not engaged in a trade or business or a non-profit organization. In all other cases the withholding operated at source is "on account" of the final income tax due by the taxpayer. Should the amount of the tax withheld exceed the amount of the total income tax due, the excess is refundable.

As far as international tax rules are concerned, it is to be mentioned that double taxation conventions (DTCs) concluded by Italy have standard clauses similar to Art. 11(1) of the OECD Model Convention, under which interest should in principle be taxed in the recipient's State. Nevertheless, DTCs often provide that the payer's State imposes a withholding tax at source, and in such cases any resulting double taxation may be avoided by the allowance of a foreign tax credit to the recipient. The rates of taxes withheld at source under DTCs concluded by Italy are as follows:

15%: Belgium, France, and Israel

10%: Japan, Greece, Ireland, Romania, and Trinidad & Tobago

12.5%: Switzerland

Italy has also entered into a treaty with Germany, later extended to Austria which was concluded before World War II and which completely excludes any right of the debtor's country to tax outgoing interest on ordinary loans. The double taxation treaty concluded with the Federal Republic of Germany is expected to be renegotiated in the near future, Italy concluded a new tax treaty with Austria in 1981, which is, however, not yet in force.

Generally speaking it can be stated that all Italian DTCs (except the treaty concluded with Germany) deal with "associated enterprises" in line with the OECD Model Convention, thus implying the application of the arm's length rule in all transactions between associated enterprises.

On the other hand, it is to be noted that only a minor part of Italian treaties covers the problem of loans entered into between related parties. This item (in accordance with the definition given by the OECD model) is covered as follows:

> Where owing to a special relationship between the payer and the recipient, or between both of them and some other person, the amount of the interest paid, regarding the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being given to the other provisions of this Convention applied only to the profits similar to the last-mentioned amount. In this case the taxable percentage provided is not applied to this last-mentioned amount (DTCs with Belgium, France, Japan, Greece, Ireland, Israel, Romania, Switzerland, Trinidad and Tobago).

Two main consequences provided by the internal law are non-deductibility of excessive interest paid and fines and penalties. It is to be noted, however, that criminal penalties might also be applied according to the existing Foreign Exchange Regulations.

Where treaties limit or exclude the right of Italy to tax outgoing interest, withholding at source should be in principle reduced or omitted. Nevertheless, the Italian tax authorities maintain that Italian debtors *should in any case* withhold the tax at source, and the creditor should apply for a refund and submit valid evidence that he has no permanent establishment in Italy. The Ministry of Finance has, however, authorized Italian debtors (only for payments to residents of a limited number of foreign countries) to reduce or omit the withholding at source, within the limits provided for by the DTC under the following conditions: (a) the Italian debtor obliges himself to submit the evidence that the creditor has no permanent establishment in Italy; (b) should the tax authorities prove the existence of such a permanent establishment of the creditor (even if unknown to the debtor), the debtor accepts to become automatically responsible for the tax and the penalties due. Evidence of the absence of a permanent establishment in Italy can be furnished by submitting the declaration of the competent foreign tax authorities stating that to their knowledge the foreign taxpayer has no permanent establishment in Italy. Declarations of major foreign leading banks (who normally deal with foreign creditors) may also be of help.

PART II – INTEREST RECEIVABLE

1. Taxation of interest income

Generally speaking, interest received (whether received from a resident or a non-resident debtor) by a resident of Italy, is fully taxable in that country. Being residents of Italy subject to tax on the basis of their world-wide income, the question whether the interest is foreign-source income or not is in principle not relevant. Foreign-source income, if connected with a trade or business exercised abroad, may only benefit from relief from the local tax (ILOR), but only if the income has been received through a permanent establishment abroad.

Interest received is taxed on a cash basis when the recipient is an individual or a non-profit organization not engaged in a trade or business, and on an accrual basis in all other cases. Interest on bonds issued abroad or on foreign bank accounts is subject to withholding at source by the Italian authorized bank charged with the transfer of the money to Italy. The withholding at source will be a "final" withholding or a withholding "on account" depending upon the nature of the interest and the category of the taxpayer.

2. Consideration of foreign taxes on income from interest in assessing the recipient of interest

Up to 1 January 1974, Italy had a tax system based on the territoriality principle. The absence of a credit for foreign taxes, conceivable only if foreign income is taxable, was the natural consequence of the old system.

The new method of taxation, based on the world-wide principle, had to introduce a credit for foreign taxes to avoid or minimize the double taxation problems. As a consequence, rules governing the application of the tax credit are relatively new and there is a wide lack of experience regarding them.

The main characteristics of the tax credit as enacted in Italy are the following:

(a) the tax credit is available to both individuals and legal entities;

(b) the credit is allowed for income tax "definitively" paid abroad, i.e. the credit cannot be allowed for foreign taxes for which a refund might still be obtained;

(c) the maximum creditable amount cannot exceed that part of the Italian tax which is proportional to the ratio between foreign-source income and total taxable income;
(d) if the foreign tax is higher than the maximum creditable amount the excess of credit is definitively lost (no carry-forward allowed);
(e) taxes levied by countries granting full tax credit to Italian residents (reciprocity principle) are fully creditable in Italy (within the limits set forth under (c) above). Income taxes levied by countries not granting reciprocity to Italian residents are creditable up to 90% of their amount;
(f) the basis for the credit (within the limits set forth under (c) above) is gross interest, and expenses, if any, are to be taken into consideration in the computation of the total Italian tax due, as a deduction from total gross income (only in case of business income).

The Italian law governing the tax credit does not specify whether the credit is to be computed on the basis of the "per country limitation" method or the "overall limitation" method. The Government has not yet issued any ruling regarding this subject and the wording of the law is ambiguous so that arguments for both interpretations exist. It is likely, however, that the eventual official interpretation will be in favor of the "per country limitation" method which is normally less advantageous for the taxpayer.

As far as bilateral measures for avoiding double taxation are concerned, it may be useful to recall that DTCs concluded by Italy covering interest (the U.S.-Italy treaty does not cover interest at all) prescribe taxation in the creditor's country.

Some of the treaties provide for the possibility of withholding at source in the country of the debtor, and in such cases a tax credit is allowed. Such measures had been enacted prior to the introduction of a general tax credit in Italy, and are therefore now of little benefit to resident taxpayers.

PART III – TAXATION OF DIVIDENDS

With the introduction of Law No. 904 of 16 December 1977, Italy has moved from a "classic" system of taxation of dividends (taxes levied both on the corporation and on the shareholder) to the imputation system, i.e. a system under which taxes paid by the distributing company are neutralized by a corresponding tax credit allowed to the recipient, whether an individual or a corporation. It is interesting to note that Italy has moved from a situation which heavily penalized dividend income (40% tax levied on a distributing company plus 50% final withholding tax or normal income tax on amounts actually distributed) to a system which is probably one of the most liberal in the Western economy.

Under the previous tax system, individuals had to report dividends on a cash basis, while companies had to report them on an accrual basis. Law No. 904 has now set out the general principle that dividends, in all cases, must be taxed on a cash basis. Therefore, companies wishing to record these dividends on a cash basis in their taxable income must do so by deducting accrued dividends from commercial income.

The imputation system: Tax credit for dividend income

According to Law No. 904, dividend income received by any taxpayer must be increased (grossed up) by one third and this amount must be included in the total amount of the taxpayer's income. Taxpayers are then allowed a tax credit equal to the amount (one third) by which the dividends were grossed up.

Law No. 904 must, however, be coordinated with subsequent legislative changes which occurred in 1982 and 1983.

Through Decree No. 688 of 30 September 1982, corporation tax was increased from 25% to 30%.

The above change required some adjustments of the tax credit on dividends inasmuch as the 1/3 credit could no longer assure to the dividend beneficiaries (subject to corporation tax) the neutrality on the dividend received.

Thus, through Art. 6, Decree-Law No. 688 of 30 September 1982 converted, with amendments to Law No. 53 of 23 February 1983, the tax credit on dividends received by companies and by the financial entities indicated in Art. 19 of Decree Law No. 95 of 8 April 1974 (converted with amendments to Law No. 216 of 7 June 1974) and the credit was increased to 42.85% of the profits which are included in the taxable income for corporation tax purposes.

By this method, which will be illustrated in detail below, *full credit of the corporate income tax (IRPEG) paid by the distributing company is given to the recipient company.* The main consequences of the above are the following:

(a) individual taxpayers will receive the same amount of gross dividend no matter how many companies there are between the final recipient and the company which originally produced the income;
(b) as a consequence of the credit, privileges (reduced tax rates) previously available to pure holding companies have now been abolished.

It is to be noted that the Italian imputation system does not provide for an "equalization tax" on dividends distributed by tax-exempt companies. Consequently, dividends distributed by a tax-exempt company *can benefit from a tax credit for taxes which have never been paid by the distributing company.* This decision was made by the Government in order better to stimulate investments in depressed areas of Southern and Central Italy. A few examples will be given below.

1. Companies which can distribute dividends benefiting from the imputation system

Subject to the treatment provided in Law No. 904 are all dividends distributed by companies listed in Art. 2(b) of Decree Law No. 598 of 29 September 1973, namely, the following:
- stock companies (Società per azioni, or "SPA");
- limited share partnerships (Società in accomandita per azioni, or "SAPA");
- limited liability companies (Società a responsabilità limitata, or "SRL");
- cooperatives (cooperative); and
- mutual insurance companies (Società mutue di assicurazione),

which have *either* their legal seat, *or* administrative headquarters, *or* principal business purpose within the territory of Italy. In other words, the companies listed in Law No. 904 are, for tax purposes, *deemed to be resident corporations.*

2. Taxpayers entitled to the imputation credit on dividends received

The tax credit for dividends received can only be taken by:
- resident "shareholders", and
- non-resident "shareholders" *who have a permanent establishment within the territory of Italy.*

The term "shareholders" expressly includes individuals and companies, whether incorporated or not. Should "shares" be owned by resident partnerships, the tax credit is to be proportionally attributed to the partners.

3. Situations where the imputation system does not apply

A tax credit cannot be claimed:
- by shareholders who opt for the 30% final withholding tax;
- by shareholders who by law are subject to final withholding at source (holders of "saving stock" (azioni di risparmio), subject to a 5% final withholding tax);
- by non-resident shareholders (individuals or companies) who have no permanent establishment in Italy;
- when a company's profit is attributed to non-shareholders (e.g. directors).

4. The imputation system: Its computation – ordinary case

Company A is fully owned by Company B.

Company A

– Company A income before taxes	100.00
– ILOR 15% (as accrued)	15.00
IRPEG taxable income	85.00
– IRPEG 30%	25.50
Net distributable income	59.50

Company B

Computation of taxable income

– Dividends received from A	59.50
– Gross-up by 42.85% of the dividend	25.50
IRPEG taxable income	85.00
Tax due: IRPEG 30%	25.50
Net income distributable by B	59.50

The IRPEG tax due by B will be completely offset by the tax credit allowed to B. Company B, in fact, is allowed a tax credit equal to the amount by which the dividends received were grossed up.

In conclusion, it can be noted that the tax credit fully neutralizes IRPEG paid by Company A.
In fact:

(i) IRPEG taxable income is absolutely equal for Company A and for Company B;
(ii) Net distributable income is also equal for both companies.

5. Withholding "on account" and excess tax credit

With reference to the example given in 4. above, it is to be noted that both Company A and Company B (like any other companies distributing dividends to resident recipients) must effect a 10% withholding tax on the distributed dividends of 59.50.

At the end of the year Company B's situation will therefore be the following:

COMPANY B
Balance sheet as of 31 December 1983

– Cash	53.55	– Reserve for taxes	25.50*
– Receivables		– Net income after taxes	59.50
Ministry of Finance for withholding tax	5.95*		
Tax credit	25.50*		
Other assets	1	Capital and liabilities	1
	86		86

* Receivables for the tax credit and withholding taxes could be better indicated as "prepaid taxes", or as a deduction from the reserve of taxes. Please note that the excess of *current* tax receivables over *current* taxes due must be refunded by the Government and cannot be used for the payment of income taxes due for other periods.

From the above table the following can be observed:

(i) B's reserve for taxes is equal to the amount of the tax credit, which can therefore be offset;
(ii) Company B does not have enough cash to pay all the dividends. In effect, though its net distributable income is 59.50, Company B's cash is only 53.55.

6. Imputation system and tax exemptions

As already stated, the tax credit is always allowed in the amount of 42.85% of dividends received. Therefore, the tax credit is also allowed when the distributing company has not actually paid the taxes for which the credit is allowed. This means that the gross income of a taxpayer receiving dividends from a *tax-exempt company may be* *higher than that of the distributing company itself.*

For example, let us assume that Company A is a company set up in the Mezzogiorno (Southern Italy's depressed area) and that all its distributable net income is distributed to Company B:

Company A

–	Gross income before taxes	100.00
–	ILOR 15% (10-year exemption)	—
–	IRPEG 30% (10-year reduction to 15%)	15
	Net distributable income	85

Company B

–	Gross dividends received	85 *
–	42.85% gross-up	36.42
	B's IRPEG taxable income	121.42

* For purposes of this computation, the application of the 10% withholding tax has been disregarded.

It is to be noted that Company B's taxable income actually amounts to 121.42. In fact, should Company B incur losses for a corresponding amount, the Government will actually reimburse the amount of the credit, i.e. a total of 36.42.

The situation set forth above also becomes more interesting if Company B is also a Mezzogiorno company, and as such entitled to a tax exemption.

In this case, Company B's taxes due would be as follows:

–	Taxable dividend	121.42
–	Tax due 15%	18.20
	Net distributable income	103.20

7. The imputation system does not apply to foreign dividends

The imputation system cannot be applied to foreign-source dividends. However, in order to reduce the burden of Italian taxes on foreign dividends, Law No. 904 has introduced the principle that foreign dividends received from foreign controlled corporations are 40% taxable, and thus 60% exempt. For purposes of Law No. 904, foreign controlled corporations are defined as foreign companies at least 10% of whose capital is owned by the recipient. Should a foreign company be listed on a foreign Stock Exchange, only 5% of its capital must be owned by the recipient. However, the tax credit for foreign withholding taxes paid abroad is allowed, within the limits provided in the law.

8. Imputation system and non-resident recipients

Non-resident recipients can benefit from the tax credit on dividends only if they have a permanent establishment in Italy. As far as dividends are concerned, it is to be noted that Law No. 904 has formally provided for the "force of attraction principle" of the permanent establishment.[1]

It can therefore be concluded that in the case of a permanent establishment, the shares of Italian subsidiaries (or any interest in Italian companies) must statutorily be included in the permanent establishment's balance sheet. Such a statement leads to the further conclusion that any capital gains realized at the moment such interests are sold are taxable to the permanent establishment.

The following table shows the tax impact on income produced in Italy by a subsidiary of a foreign company, assuming that:[2]

(a) the foreign recipient has a permanent establishment in Italy;
(b) it has no permanent establishment.

		Permanent establishment	
		Yes	No
–	Gross income before taxes produced by the Italian subsidiary	100.00	100.00
–	IRPEG and ILOR on this income	40.50	40.50
	Dividends distributed	59.50*	59.50
–	Taxes due by the Italian permanent establishment on dividends as grossed up by 42.85%**	25.50	—
–	Tax credit allowed to the permanent establishment	25.50	—
	Net transferable abroad	59.50	
–	30% withholding tax to be effected on dividends remitted directly abroad	—	17.85
	Net abroad	59.50	41.65

* The subsidiary paying a dividend to a permanent establishment of a foreign company must effect a 10% withholding. Such prepaid taxes will be either used by the permanent establishment to offset tax liabilities (including income not subject to withholding) or can be refunded. See 4 above.

** Art. 6 of Decree Law No. 688 grants the 42.85% tax credit to "companies and financial entities". The special relief should thus apply also to foreign companies having a permanent establishment in Italy which according to Law No. 904 of 1977 are expressly entitled to the tax credit (indeed, the permanent establishment of a foreign company is not recognized as an autonomous fiscal entity and the taxpayer continues to be a non-resident company).
However, the applicability of the 42.85% credit to foreign companies with a permanent establishment in Italy has not yet been confirmed by the Ministry of Finance.

1. Under the "force of attraction principle", all items of income are included in the income of the permanent establishment when this income is received from sources in the country of the permanent establishment regardless of whether the income is derived through the permanent establishment or not. All such income is therefore taxed as if income of the permanent establishment.
2. This table does not take into consideration either the possibility that the subsidiary may benefit from some specific tax exemption or the possibility of a lower withholding tax rate provided by a treaty.

The following countries have concluded treaties for the avoidance of double taxation of income and/or capital with Italy:

Arab Republic of Egypt	Japan
Argentina	Luxembourg
Austria	Morocco
Belgium	Netherlands
Brazil	Norway
Canada	Portugal
Denmark	Romania
Finland	Spain
France	Sweden
Fed. Rep. of Germany	Switzerland
Greece	Trinidad and Tobago
Hungary	United Kingdom
Ireland	United States
Israel	Zambia

9. Transfer of retained earnings to capital

Stock dividends derived from a transfer of reserves to capital are always considered to be tax-exempt. However, returns of capital to stockholders are treated as dividends if the reimbursement is made within 5 years from the transfer of the retained earnings to capital, and up to the amount so transferred. Let us assume the following example:

– Paid-in capital	280,000
– Undistributed profits	70,000
Total capital	350,000

Company A makes the decision to transfer to capital the previous year's undistributed profits, and consequently assigns one new share for each 4 shares already owned. The face value of each new and old share is 10. Three years later, Company A decides to reduce its capital and reimburse 35,000 to its shareholders. The value of *each single* share will be reduced from 10 to 9 (10% reduction in capital, so 10% reduction in the value of the shares) and the amount so distributed will be considered a dividend subject to the withholding tax and to the imputation system of taxation.

Conclusion

The introduction of the imputation system for the taxation of dividends has put Italy on the same level as other more advanced countries.

The new system is very generous and seems to be particularly stimulating in the case of investment in the tax-exempt regions of Southern Italy. The Italian imputation system in fact does not provide, as others do, for the "equalization tax" on dividends paid by tax-exempt companies (removing the benefit of the tax credit) and this permits either the shifting of the exemption to the shareholder, or even a "tax profit" for the ultimate shareholder.

Law No. 904 of 1977 has introduced a system that is completely new for Italy.

Investors were forced to modify and adapt their plans to this law, which had more than a minor impact on the entire Italian economy; careful tax planning on the part of both resident and non-resident investors is therefore of the utmost importance.

[Continued from p. 407]

At 31 December 1981 the capital owned is 1,300 lire and the credit balance of monetary revaluation is 965: that is, the reserve to be entered on the debit side of the balance sheet is equal to the difference between the revaluation of the increases and the revaluation of the decreases, applying to each change the coefficient that applies to the year in which they were effected.

Once one has determined the grand total of the balance on the credit side of the monetary revaluation, the company can revalue the goods listed in the asset side of the balance sheet, provided that:

(1) the value of the revalued asset does not have a value higher than its actual real value;

(2) the total amount of the revaluations of the assets is not higher than the revaluation balance entered among the liabilities of the balance sheet.

The revaluation of the single goods in the assets is independent from any reference to revaluation of the respective historical costs: consequently, the company can revalue some goods according to economic and not monetary principles, so as to enter in the balance sheet higher values than one would obtain by the direct method.

6. Professional and accountancy principles

The Accountants and Tax Consultants have elaborated "accountancy principles" with reference to the drawing up of the balance sheet.

These accountancy principles amount to an independent interpretation of civil code laws on drawing up the balance sheet, as well as the procedure of the passage from the income that is given by the civil balance sheet to the "assessable income" according to tax legislation.

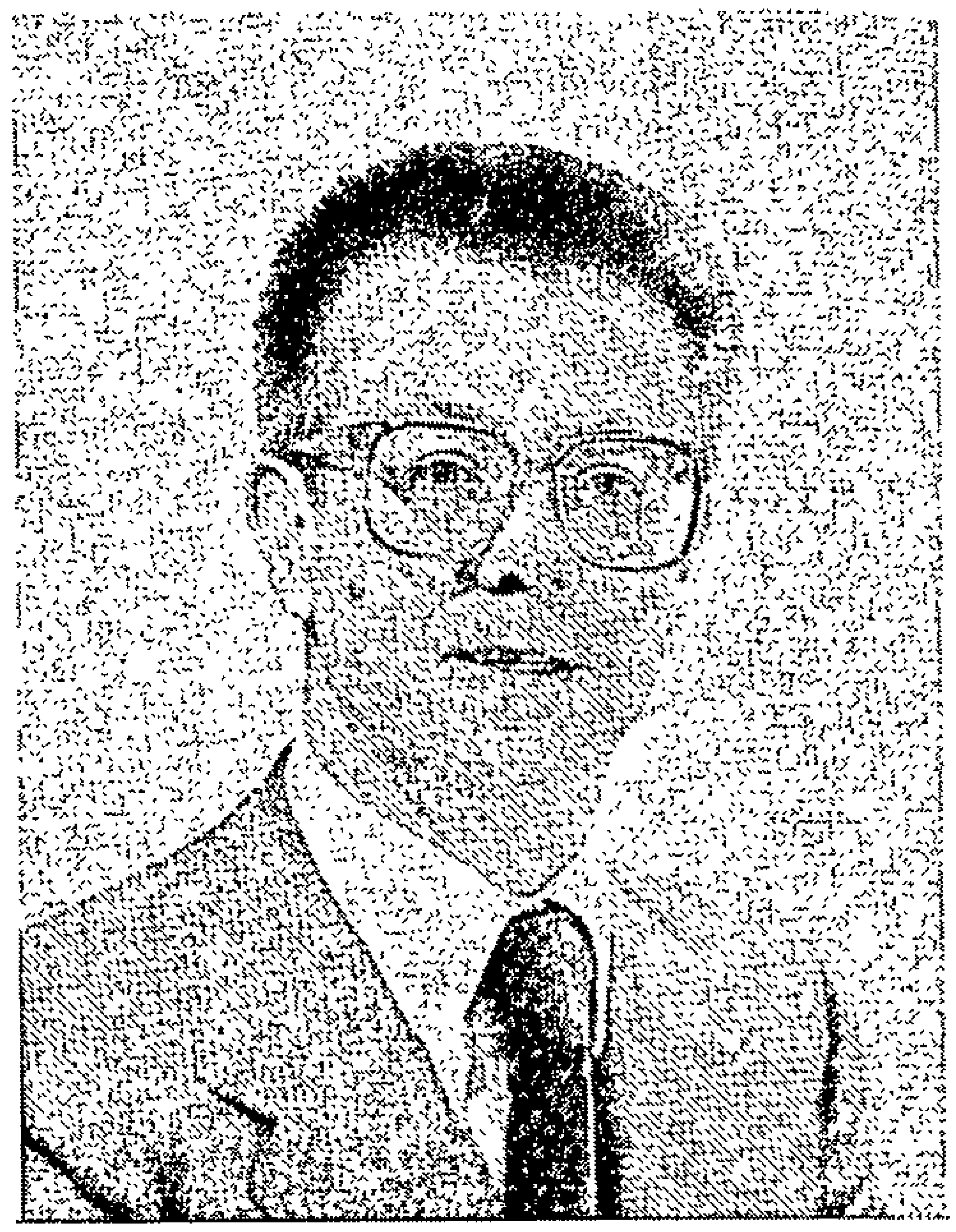
The accountancy principles elaborated by the Profession have been recognized as "reference points" by CONSOB – The National Commission on Companies and the Stock Exchange (Deliberation No. 1079 of 8 April 1982 – for drawing up the balance sheet of companies listed in the Stock Exchange.

Payment of Taxes and the Ability to Pay in Italy

Article 53 of the Constitution in the Case Law of the Constitutional Court

By Gianni Marongiu

The cases of the Constitutional Court which are discussed here can be read in their entirety in "Review of constitutional questions" (edited by Prof. Gianni Marongiu) which appears every 4 months in the journal *Diritto e Pratica Tributaria* (i.e. in the 1st, 3rd, and 5th issues of this journal).



Gianni Marongiu, who is a partner of the law firm *V. Uckmar, Associazione professionale,* was borne in 1937 in Turin (Italy). He obtained his law degree cum laude at the University of Genoa in 1960. In 1962 he was admitted to the Bar of Genoa. From 1963-1969 he was Assistant to the Chair of the Science of Finance, Faculty of Law, at the University of Genoa. In 1969 he was appointed Lecturer at the Faculty of Economics and Commerce of the University of Trieste which post he held up to 1977. In that year he became Professor of tax law at the Faculty of Law of the University of Genoa.

He is a co-executive director of the journal *Diritto e pratica tributaria* and a member of the scientific advisory board of the journal *La finanza locale.* In 1976 he was the Italian reporter to the IFA Congress on the subject "Inflation and taxation". He is the author of some 150 publications.

1. INTRODUCTION

The question of the relationship between the Constitution and the tax system has become a very interesting and topical subject. The author believes that in considering this question it is necessary to bear in mind that not only are the fundamental principles to which ordinary laws must conform and the values which should guide interpretative choices to be found in the Constitution, but also (if not above all) that the particularly significant and profound role played by the participation of juridical operators (in a broad sense) in the development of our system is manifested in the control as to the constitutionality of laws, as regulated in our system.

In fact, it is normally up to the interested party to raise the question of the constitutionality of the applicable norm and to submit this question to the judge. Then it is for the latter to decide whether or not the question is relevant, and if he holds that it is relevant, whether or not there are grounds for the submission. If he finds that the submission is not manifestly groundless, he will refer the case to the Constitutional Court. Finally, it is for the Constitutional Court to give judgments which either through their efficacy *erga omnes* change the pre-existing system (if they uphold the submission of unconstitutionality) or in any case affect the system if they merely interpret or dismiss the submission of illegality.

Thus the system is modified through the working of an instrument which is inherent to the system, and which is operated by the organs of justice rather than the normal representative organs.

These points have already been noted many times but they are repeated in order to introduce a more precise examination of the case law relating to Art. 53, and, finally, so as to reach some conclusions.

2. EARLY TRENDS AND RECENT CONTRIBUTIONS TO THE ANALYSIS

Art. 53 of the Constitution provides that all persons are required to contribute to public expenditure according to their capacity to contribute (1st paragraph) and also that the tax system bears the mark of progressiveness (second paragraph), and this undoubtedly constitutes the most important rule laid down by our Constitution with regard to taxation.

Although this rule was introduced into the Constitution without great difficulty, it frequently gave rise to new and difficult problems of interpretation for several years after it came into force.

Financial economists denied that any concrete significance could be attributed to the concept of the capacity to contribute so as to explain the actual importance of Art. 53. In addition constitutionalist and fiscal theory (which was older) declared that Art. 53 did not have a precise normative content and merely expressed a simple constitutional directive (it was described as a purely programmatic rule) eventually replacing the opinion of the ordinary legislature.

Therefore, no significance could be attributed to Art. 53 other than the confirmation of the historic declaration of the citizen's duty to contribute to the burdens of the State, and of the principle that those who have the same capacity to contribute should be taxed equally.

This first legal obstacle was overcome when more balanced legal thought and more authoritative case law explained the fallacy of the theory according to which only those norms which appear to be detailed precepts merited consideration, that only to those norms could a legal character be attributed, and which characterized other norms as simple "programs" for future legislation. In fact, the Constitutional Court has since its first judgment specified that the "well-known distinction between prescriptive and programmatic norms is not decisive in judgment as to constitutional legitimacy" (see Constitutional Court, 14 June 1956 No. 1; and for a specific declaration that Art. 53 has prescriptive and not purely programmatic value, see Constitutional Court, 6 July 1978, No. 120).

It has undoubtedly been the merit of acute legal thought to indicate, on the methodological plane, the exact criterion for the interpretation of Art. 53.

The first problem to be solved was whether to follow a specific economic or financial theory, and it was made clear that for the purpose of determining the actual significance of Art. 53 one must, in order to avoid confusion between theories which have different principles and methods of study, leave out of consideration results obtained from theoretical research simply because these results are valid only within the ambit of their premises and cannot be extended to a field where the primary datum is constituted by the norm (see E. Giardina, "The theoretical phase of the principle of the capacity to contribute", Milano, 1961).

This was the first and important step which made clear that if the phrase "capacity to contribute" referred to (in accordance with its common meaning) the economic capacity which reveals a potential for the contribution to the public burden, then the lawyer – who is faced with a tax system which consists of numerous taxes each of which has a distinct taxable object – cannot avoid ascertaining how the ordinary legislature's obligation, not to exceed in the exercise of its taxing power the limits manifested in the economic resources of the taxpayer, is reflected in the choice of the facts to which a person's tax obligation gives rise.

Giardina concluded that, although it is recognised that the ordinary legislature has ample discretion as to the choice of facts to subject to tax, that discretion is nevertheless not unlimited since Art. 53 lays down that the taxation must be in accordance with the capacity to contribute. This requires that the facts chosen demonstrate wealth and economic power so that in the light of this rule the legislature's choice – with regard to both the facts which give rise to the tax and the criteria for the calculation of the taxable base – can be controlled.

Furthermore, another author added, "Art. 53 enunciates one of the fundamental public duties, but there is nothing to indicate that in the order of constitutional values any prevalence is given to the interest of the fisc, and, indeed, the most significant part of the Article consists of the determination of the limits within which the taxing power can legitimately be exercised" (see Crisafulli, "About the capacity to contribute", in *Giurisprudenza Costituzionale* 1965, 857).[1]

So, once the parameters for subsequent research were determined, this showed itself to be alive, concrete and capable of rapid further development with regard to the objective and subjective ambit of the application of Art. 53, the concept of the capacity to contribute and the requirement for reality, as well as the Article's impact on a different problem which concerns the equality of treatment for taxpayers.

The author believes that concrete references to case law [only the requirements of space prevent us from lingering over the most important theoretical contributions (see the most recent monograph by F. Moschetti, *The principle of the capacity to contribute*, Padova, Cedam, 1973)] can give a precise idea (even if only panoramic) of the effect of the Constitutional Court on the normative order; the Court has in fact gone well beyond the important affirmation of the principles that "every fiscal levy must be justified by indications which concretely reveal wealth" (Constitutional Court, 6 July 1972, No. 120) and that "the reference of that presupposition to the sphere of the taxpayer must result from a real connection, and that one must refer to an actual indicator in order to calculate the amount of tax which can be exacted from each taxpayer" (Constitutional Court, 26 June, 1965, No. 50).

3. THE OBJECTIVE AMBIT OF APPLICATION

With regard to the objective ambit of application, the Constitutional Court has explicitly recognised that Art. 53 applies not only to direct taxes, but also to indirect taxes (Constitutional Court, 6 July 1972, No. 120). Nor can we exclude the "contributions relating to specific improvements" (to real estate), the tax which is, among other things, based on the philosophy that a taxpayer through the effect of a public measure of general utility has received a benefit with respect to the real estate he holds.

The Constitutional Court has indeed observed that in both case law and theory the tax nature of such contributions is commonly recognised (even if their characterization is more controversial in comparison with that of other taxes and duties) and there are no valid reasons for the exclusion of the application to these contributions of the principles contained in the 1st paragraph of Art. 53

1. Professor Crisafulli became a judge of the Constitutional Court.

(in particular, those relating to the capacity to contribute). The Court gave two reasons. Firstly the constitutional formulation ("to contribute to public expenditure") is very broad. Secondly, an exception has already been made with regard to the supply of certain services, the cost of which can be determined by division and which refers only to the particular case of procedural costs provided for by Arts. 488 and 613, Penal Procedure Code (Constitutional Court, 22 April 1980, No. 54). In the case referred to, No. 30 of 1964, the Court held hat "Art. 53 does not concern those legal expenses the amount of which can be computed (in relation to every single act, and which can therefore individually burden the persons who gave rise to the expenditure; Art. 53 is applicable only to the costs of the general organisation of judicial services which are sustained by the State in the interest of the community as a whole."

The Court reached the same conclusion with regard to discounts imposed on manufacturers on the price of medicine in favour of insurance bodies as a form of so-called indirect assistance: "we are in fact dealing with an obligation of a tax nature (Judgment No. 144 of 1972) so that the principles laid down by Art. 53 apply" (Constitutional Court, 10 July 1975, No. 201).

On the other hand, the Court held that with regard to the supplementary tax, "any reference at all to the constitutional principle of contribution to public expenditure according to each person's capacity to contribute is out of place" in that "because of its penal nature and compensatory function the supplementary tax is a sanction, and it is different and distinct from the tax obligation the non-fulfilment of which it punishes, nor does it serve the same ends as taxes do" (Constitutional Court, 5 July 1973, No. 109).

4. THE SUBJECTIVE AMBIT OF APPLICATION

The case law of the Constitutional Court has not only analysed which pecuniary obligations constitute "contributions to public expenditure", but has also dealt with the subjective aspect, that is to say, it has contributed to the characterization of who or what is the subject which is "bound to contribute to public expenditure". The question is not unimportant since Art. 53 lays down a link between "all" persons (who are bound to contribute) and "their" capacity to contribute.

This means, not only that those who contribute to public expenditure must pay according to their own, and not anybody else's, capacity to contribute; but also that the capacity to contribute must give rise to an obligation on the part of the persons who are capable, rather than anyone else, to contribute to public expenditure. The application of these criteria is found in the judgment in which the Constitutional Court held unconstitutional the following rule contained in the repealed Registration Law. Through this rule the tax was imposed on persons who were unconnected with the agreements on which petitions to the judge were based, and who did not instigate the proceedings, or if the proceedings were simply pending before the same judge after the joinder of actions which were started separately.

The court stated that:

> The requirement for a link with the capacity to contribute does not exclude that the law may establish tax obligations as the joint liability of not only the principal debtor, but also of other persons who are not direct participants in the act which is assumed to indicate the capacity to contribute. However, in this case it is necessary that such imposition is legitimated by the juridical-economic relations between these persons, who can rationally justify the legal obligation and its economic rationale.
>
> In other words the joint liability of a subject (A) in respect of tax debts of another subject (B) is allowed only where there is a legal and economic relation between A and B related to the tax debt.
>
> Thus, the purchaser of a property is jointly liable with the seller for the payment of registration tax inasmuch as the joint liability derives from an underlying economic and juridical arrangement (the sale of the property) related to the tax liability.
>
> By contrast, for instance, the lawyer cannot be held jointly liable with the client for paying registration tax on a judgment regarding a controversy between the client and third parties inasmuch as there is no relationship between the legal-economic fact giving rise to the tax (object of litigation and judgment) and the relationship between the lawyer and the client (Constitutional Court, 6 July 1972, No. 120).

In the same judgment, the Constitutional Court held as unconstitutional another rule in the repealed Registration Law. This rule imposed, upon attorneys representing clients in legal proceedings, a joint liability, with their clients for the so-called legal taxes. The Court observed that "the attorneys are extraneous to those situations and facts to which the judgment relates, and with which the law is concerned for the purpose of imposition of tax" so that "their responsibility is thus determined by the interest of the fisc in realising a tax claim without any element serving to link, rationally, the obligation of the attorneys with the tax, emerging (as is the case for other categories of people liable for taxes) from the rule in question."

To summarize, it could be said, as the Constitutional Court has remarked, that "the capacity to contribute should be understood to mean subjective suitability for the tax obligation, and this suitability can be deemed from the presupposition to which the obligation is linked" (Constitutional Court, 16 June 1964, No. 45; Constitutional Court, 10 July 1975, No. 201).

5. THE CONCEPT OF THE CAPACITY TO CONTRIBUTE

Once the duty to contribute to public expenditure was characterized with regard to both its objective element (whose pecuniary obligations constitute contributions to public expenditure) and its subjective element (who contributes to public expenditure), case law analysed the presupposition for the legitimacy of this duty: the capacity to pay taxes. Case law agreed, after early interpretative uncertainties, in conformity with the theory, that "the principle of the capacity to pay taxes should be understood as an expression of the requirement that each fiscal levy must be justified by concrete indications of wealth" (Constitutional Court, 6 July 1872, No. 120;

Constitutional Court, 10 July 1975, No. 201).

Therefore, as has already been said, it must be concluded that any fiscal levies which are not linked to signs of the wealth of the taxpayer are not permitted by the Constitution and are therefore unconstitutional. As the Constitutional Court stated, "the question which logically precedes the principle of the capacity to pay taxes is that which concerns the existence of an indication of capacity as a presupposition for legitimate taxation" (Constitutional Court, 22 April 1980, No. 54).

a. The reference to economic strength and the verification of its indices

In the light of this criterion the Court declared unconstitutional the rule (Art. 15 of Law No. 541, 5 July 1961) which taxed certain ideological propaganda effected without a profit motive directly by the interested parties because "in the display of posters or the personal distribution of manifestos no signs of income or expenditure can be recognised" which justify the tax (Constitutional Court, 16 July 1973, No. 131). Subsequently, the Court held that ideological propaganda effected without any profit motive through the circulation of persons with cars, dit not in itself constitute any sign of income or expenditure which could justify the imposition of the tax on publicity (Constitutional Court, 26 July 1979, No. 89, which declared the illegitimacy of Art. 12 of Decree No. 639, 1972, which contained the rules governing the imposition of the municipal tax on publicity and posters).

Consistently with the above, the Court held, with regard to the so called "Supertax for Calabria", that "the presupposition of inscription of a tax in the Roll of taxes does not reveal a different and autonomous capacity to pay taxes".

A few years later the Constitutional Court was required to judge the legitimacy of a special supertax which was applied to the "tax relating to improvements in land" with reference to the year in which that tax was collected. The Court declared that the supertax was unconstitutional because "the link with a genuine indication of capacity is missing from the rules in question in that for the imposition of the supertax reference is made, not to a fact which concerns an increase in income, but purely to the inscription in the Roll of taxes for the annual imposition of the tax relating to improvements in land" (Constitutional Court, 22 April 1980, No. 54).

b. The exemption relating to the minimum necessary for life

The Constitutional Court held that if the capacity to pay taxes constitutes the presupposition for legitimate imposition, it can be deduced that this capacity is not equal to the receipt of just any income, and that can only be imposed when the material means are available. Therefore, the exemption from the supplementary tax (the case concerned the personal progressive tax on the income of individual persons which was repealed in 1973 and replaced by IRPEF)[2] for subjects who enjoy a very small income appears to be fully legitimate, being linked to a rational presumption that any capacity to contribute is missing.

The Court has also said that, "furthermore, it must be noted that this exemption is not just legitimate, it is in fact fair since if the legislature has the discretionary power to establish, by reference to complex social and economic evaluations, what is the minimum amount above which arises the capacity to pay taxes, the legislature cannot refuse to exempt from taxation those subjects whose income is so small as to be barely sufficient for life's basic necessities" (Constitutional Court, 10 July 1968, No. 97).

6. THE REQUIREMENT FOR ACTUALITY

In order to complete this enquiry into the concept of capacity to contribute, it is now necessary to specify what are, according to case law, the characteristics and essential attributes of that capacity, and what are its concrete consequences.

I have already noted the important legal tenet according to which "the reference of the presupposition to the sphere of the taxpayer must result from an *actual* link, and one must refer to an actual indication in order to determine the amount of tax which can be exacted from each taxpayer" (Constitutional Court, 26 June 1965, No. 50).

The Constitutional Court held in this decision and repeated (Constitutional Court, 1967, No. 109) that the concept of "capacity" necessarily refers to actual potential, that is to say, to concrete, certain and present potential.

a. Retroactive taxation

Moving from the premise that the concept of the capacity to contribute requires actuality – a logical requirement which no one doubts – the Constitutional Court faced the most important and significant question concerning the constitutional legitimacy of retroactive tax laws (the Italian Constitution, by virtue of Art. 25, expressly prohibits retroactivity only with regard to penal laws); in other words, the question was asked whether a retroactive tax law is in itself contrary to the principle of the capacity to contribute.

The Court did not adhere to the most radical thesis, and held that in each case, with regard to the individual tax law, it is necessary to check whether the law by taking as object of the tax, facts or situations which occurred in the past, or through the extension of its effect into the past, changing the elements from which the fiscal obligation draws its essential characteristics, has broken the necessary relationship which must exist between imposition and the capacity to contribute, and has thus violated the constitutional rule (Constitutional Court 16 June 1964, No. 45).

Therefore, the law can affect the capacity to pay taxes which existed before the law was enacted and which was

2. Imposta sul reddito delle persone fisiche.

revealed by past facts only if the law is supported by the rational presumption that the capacity still exists at the moment of imposition (Constitutional Court, 8 July 1982, No. 143). In practice, the Constitutional Court declared unconstitutional a rule which permitted the application of the tax on building sites (Arts. 48 and 49, and second paragraph of Art. 25, Law No. 246 of 5 March 1963) to operations carried out in the decade which preceded the enactment of the law, on the grounds that the rule conflicted with Art. 53: "In this case there is the application of the tax to relations which no longer exist without the rule's retroactive effect being supported by any rational presumption that the economic effects of the alienation (and the value realised thereby) remain part of the taxpayer's wealth given the fact that the alienation occurred very long ago when the enactment of the tax was not even foreseeable" (Constitutional Court, 23 May 1966, No. 44; see also Constitutional Court, 11 April 1975, No. 75).

b. Legal presumptions in the tax field

Another extremely interesting theme causing litigation concerns so-called legal presumptions in tax matters with regard to which the Constitutional Court holds that they, whether absolute or relative, are not contrary to Art. 53 whenever they are rationally justifiable, or respond to logical criteria, or are based on common experience (Constitutional Court, 26 May 1971, No. 107).

In the application of this rule the Court held that:
(a) Art. 18 of the old Law No. 25 of 1951 is unconstitutional. This provided the mechanism (replaced by the 1958 Consolidation Act) whereby the tax for each tax period was to be proportional to the income accrued during the preceding year so that an inconsistency was created between the object of the taxation and the criteria by which it was computed. Indeed – as the Constitutional Court has observed – "the production of income here being considered is undoubtedly a socio-economic fact which is tied to certain objective and subjective conditions of a variable nature so that even if the formulation of logically valid and reliable estimates is permitted, nevertheless the transformation of these estimates into absolute certainties which are imperatively decreed, without there being the possibility of proof to the contrary being admitted, is not allowed. Therefore, next to the established necessity of guaranteeing the interest of the Treasury in the collection of taxes, the aforesaid, equally established, right of the taxpayer to prove the reality or other modalities of the income taxed is protected" (Constitutional Court 28 July 1976, No. 200);

(b) The rules in the old "exclusive test" relating to direct taxes (in 1958) were illegitimate. These rules provided that when no tax return was filed, income from moveables could be calculated as being equal to that ascertained in the previous year, plus 10%: "the pure and simple consideration of presumed further development in the activity of the taxpayer" – said the Constitutional Court – "with the consequential increase in income is not sufficient to legitimate the increase in tax here considered because it is not based on any concrete element or positive indication" (Constitutional Court, 12 July 1967, No. 103);

(c) The rules which, for the purpose of calculating the taxable base for the application of the estate tax, presume the existence of money, jewels and furniture (Art. 31 of Decree No. 3170, 30 September 1923, and now Art. 8 of Decree No. 637 of 1974) were not unconstitutional. The Court said "the provision attacked is based on common experience and answers to principles of logic which are so important that they legitimate the legal certainty as to the existence of the goods. Furthermore, given the nature of these goods (they are easily hidden, can slip through any kind of tax assessment, and are difficult to value), it was necessary for the legislature to make the tax claims precise, the payment of tax speedy, and every attempt to evade taxes useless" (Constitutional Court, 12 July 1967, No. 109).

c. Levies which occur before verification of the taxable facts

The problem of the observance of the principle of the reality of economic potential arises in all those cases where the levy occurs before the verification of the taxability of the case in question.

The problem – which is connected with those examined in 6.a. and 6.b. above – was considered by the Constitutional Court when the so-called provisional inscriptions in the Roll of taxes (provided for and governed by Art. 176 of the Consolidation Act, 1958, No. 645) were denounced before the Court inasmuch as the provisional inscription arose from the existence of taxable items relating to previous tax periods, so that, on the basis of the provisional inscription, the taxpayer was burdened with a pecuniary obligation in favour of the public authorities on account of a tax debt which had not yet been incurred, and with regard to which both the existence and the amount were uncertain.

The Constitutional Court confirmed the constitutional legitimacy of the provisional inscriptions in the Roll of taxes. Its decision was substantially based on 3 arguments:
(a) the rationality of the presumption on which the system was based because "if one looks at *id quod plerumque accidit* it is not arbitrary to maintain, provisionally, that in the two subsequent tax periods at least as much income will be produced as was declared by the taxpayer for a particular tax period";
(b) the limited danger of injustice, bearing in mind that it was possible to avoid provisional inscription if the source of income ceased to exist;
(c) the possibility of "obtaining a refund as a balancing adjustment if the taxable income turns out to be less than that provisionally registered so that, eventually, the taxpayer pays tax on his actual income, that is to say, according to his capacity to contribute" (Constitutional Court, 3 July 1967, No. 77).

d. Reclaiming unduly paid tax because of a change in circumstances

Analogously, observance of the principle understood as *actual* potential requires the legislature to consider the situation in which the economic capacity shown by the taxable fact does not exist.

Therefore, the Court has laid down that:

> [1.] in the case where the transfer of a right which is brought about by a judgment does not exist because of a later reversal (on appeal) of the judgment, so that the object of the registration tax is missing, then any registration tax which was paid must be reimbursed (Constitutional Court, 29 December 1977, No. 200);
> [2. similarly] the same effect is seen whenever the judgment which contains the enunciation of the transfer of an unregistered right (which, however, is subject to the requirement for registration) is declared to be completely null and void or is completely reversed by a later definitive judgment and/or a retrocession of rights is inferrable from that later judgment: the deed to be registered has no substance and therefore the object of taxation is missing (Constitutional Court, 28 July 1976, No. 198).

It is noted that in accordance with this ruling, Art. 35 of the new registration tax law lays down that "the acts of the legal authorities which define (even if only partially) the verdict . . . are subject to the tax even if at the moment of registration they have been attacked or can still be attacked, but there is the possibility of balancing adjustments or refunds of the tax, based on a subsequent definitive judgment" (Decree No. 634 of 26 October 1973).

e. Taxation with the cadastral system

The requirement that in applying Art. 53 one must have regard to actual capacity to contribute does not mean that a method which refers to ordinary average income rather than actual income for the calculation of the taxable base (as is the case under the cadastral system) must therefore be held to be illegitimate.

Indeed, according to the Constitutional Court,

> when the object of taxation is something which is productive, then the base for taxation is given (and the taxpayer's tax capacity is revealed) by the potential of the goods to produce an economic income and not by the income which the owner actually receives, (i.e.) by the productivity and not the actual product. Moreover, it is right that this happens because the tax also constitutes an incentive for the adequate utilisation of the goods, and favours (amongst other things) the better performance of the duty of economic solidarity, and more ample contribution to the material progress of the country (Arts. 3 and 4 of the Constitution). The law which governs real estate taxes does not make allowances, for inertia or inability in the management of land, or the generosity of the taxpayer who, for example, does not extract adequate compensation from the use of his land (Constitutional Court, 31 March 1965, No. 16).

f. Taxation of the net taxable base

The principle of taxation of the net taxable base constitutes a further limit in the determination of the taxable base. The Constitutional Court recognised this when, with regard to the estate tax, it decided that "when the value of the estate is calculated on the basis of the difference between assets and liabilities one obtains the real taxable amount which corresponds with the actual economic value of the estate: otherwise we have a *fictitious* taxable amount" (Constitutional Court, 12 July 1965, No. 69).

The Constitutional Court has recently confirmed this, laying down that "as a general rule, it is permissible to consider that those costs and expenses which are instrumental to the production of income affect the capacity to contribute so that they can be deducted in order to obtain the taxable income. Indeed, we are dealing with elements which have a negative effect on income, that is to say on the taxpayer's wealth from which must be drawn the money necessary for public expenditure" (Constitutional Court, 8 July 1982, No. 143).

However, "it is for the legislature to exercise its discretion with regard to the characterization of deductible losses, bearing in mind the required link with the production of income, and the fundamental necessity of adopting appropriate cautionary measures to prevent tax evasion" (Constitutional Court, cit.).

Therefore, the Court said, the rule which before the 1973 tax reform did not provide for the deduction of medical expenses was not unconstitutional.

> According to the Constitution, deductibility is not necessarily general and unlimited, and the meeting-point between the opposing requirements varies according to the economic, financial and social development of the country. It is up to the ordinary legislature to determine this meeting point, bearing in mind all relevant data. This is true in general for deductible losses and personal allowances (exempt amounts and family allowances), and in particular for medical expenses (Constitutional Court, 14 July 1982, No. 134).

Analogously, the rule which subjects the deductibility of specified expenses to the condition that they are registered in chronological order in the way, and with the details, required by law, is not unconstitutional because "the calculation of the amount of tax which the taxpayer is bound to pay can well be subordinated to the fulfillment of a given obligation" (Constitutional Court, 28 December 1970, No. 201).

g. Inflation

Recently the Constitutional Court had the opportunity to formulate its position on a question which is as controversial as it is important. The question is whether the rate between the tax and actual economic potential requires that the legislature take account of continuous inflation: in fact it is clear that inflation can have a significant effect, and can assume particular importance with regard to both personal progressive direct taxes, and also certain indirect taxes.

A great number of Commissions criticised before the Constitutional Court the rules laid down for the municipal tax on increases in the value of land (Decree No. 643 of 26 October 1972) because the taxable amount is the difference between two values which were expressed in terms of the same currency although they were assessed at different times when the purchasing power of the currency differed. Therefore, the tax can be imposed on (and in times of inflation often is imposed on monetary gains) rather than real gains.

The Court held that this criticism was groundless, saying that

> It does not follow from this argument that the presence of inflationary factors must constitute an obstacle to the application of a tax on increases in the value of land, nor that the legislature can be required to purify the taxable gains of the component which is ascribable to inflation through indexation or integral revaluation formulae (Constitutional Court, 8 November 1979, No. 126). By this we obviously do not mean to exclude the possibility that the legislature may (or, in particularly serious cases, should) take into account the effects of inflation . . . . but these interventions have always been the result of political choices at the discretion of the legislative power which has the duty to provide with regard to such delicate questions on the basis of political, social, economic and financial evaluations which generally escape the control of legitimacy which was entrusted to this Court (Constitutional Court, cit.; note however, that the same judgment held unconstitutional some rules contained in Decree No. 643 for a different reason: see 7. below).

7. THE PRINCIPLES OF THE CAPACITY TO CONTRIBUTE AND OF EQUALITY: THEIR CONNECTIONS

A final most important issue concerns the connections between the principle of the capacity to contribute and the principle of equality.

Indeed the case law of the Constitutional Court has been constant in deciding that the principle of the capacity to contribute must also be interpreted as a specification of the general principle of equality (Art. 3, Constitution) in that similar situations must be taxed similarly, and, correlatively, dissimilar situations must be taxed dissimilarly (Constitutional Court, 6 July 1972, No. 120).

In fact the Constitutional Court, when declaring unconstitutional a rule which doubled the rate of the supplementary tax in favour of municipal assistance bodies, held:

> since Art. 53 constitutes, amongst other things, a harmonious and specific development of the principle of equality (Art. 3 of the Constitution), it should be translated, as far as income taxes are concerned, into the requirement for similar taxation for similar income and dissimilar taxation for dissimilar income. However, this increase in the supplementary tax, as it is presently devised, ends up by affecting each taxpayer differently without there being any apparent justification, as the situation of each of the taxpayers, considered as the presupposition for the obligation to pay taxes, is objectively identical (Constitutional Court, 13 December 1963, No. 153).

From this decision originated abundant case law which was directed towards discovering whether differences in fiscal treatment are justified by a motive which can be rationally appraised (Constitutional Court, 14 July 1976, No. 16, about dissimilar treatment with regard to the registration tax as applied to industrial machinery and the property of an agricultural estate) or by objectively different situations (Constitutional Court, 12 July 1965, No. 69, concerning inequality between agricultural and industrial firms with regard to the estate tax).

This case law fits into the even more ample context of the control of constitutionality according to Art. 3 of the Constitution "understood as a prohibition against dissimilar treatment of similar situations, and as an exclusion of unreasonable discrimination" (Constitutional Court, 25 June 1980, No. 96, on the so-called 1973 "tax-amnesty" provision). Indeed, the Court held, when declaring groundless an appeal concerning the tax treatment of urban land, "Art. 3 of the Constitution allows the legislature to evaluate objective situations and to adopt the corresponding rules, but only within the limit (if there is no rational and logical justification for treatment which exceeds this limit) of having to treat similar situations similarly, and dissimilar situations dissimilarly" (Constitutional Court, 19 April 1972, No. 62). Three years before the Constitutional Court held that in cases concerning Art. 3 of the Constitution "it is necessary to start with the verification of the existence of some reason from which it appears that the treatment for the situation for which the law intended to provide is suitable. This is because if this verification were not carried out, the principle of equality would be ineffective, almost as if it had never been written" (Constitutional Court, 10 March 1966, No. 22).

Of course it is not possible to describe the numerous relevant judgments.

However, the author believes that first of all it is necessary to specify, since the power to impose taxes does not belong exclusively to the State, that the necessity for the observance of the fundamental principle of equality is referrable to every entity which in practice exercises that power. Indeed, because of their intrinsic nature, municipal taxes respond to the requirements of the community which are typical of each municipality, so that each of the municipality's taxes are therefore ultimately different from those of other municipalities: municipal requirements determine the introduction or modalities of the tax, the valuation of the capacity to contribute, the rate of taxation, and the method of payment, so that the principles of equality and justice need normally only be observed within the local ambit.

Secondly, the author believes that this is the right moment to distinguish which judgments concern the combined effect of Arts. 3 and 53 of the Constitution.

The first group (which includes most of the cases) is constituted by those judgments where the reference to Art. 53 remained totally pleonastic in that the Court reached conclusions which it could have easily taken on the basis of Art. 3 alone, or actually resolved the controversy simply in the light of the general principle of equality. For example, the three judgments (No. 62 of 1965, No. 50 of 1970, and No. 154 of 1976) which recognised, on the one hand, the legitimacy of applying the registration tax to compulsory purchases with reference to the purchase price (even if this is lower than the market price), and on the other hand, the illegitimacy of discriminating between compulsory sales according to whether or not the sale was effected by way of an auction. There was also the case (No. 219 of 1976) where the application of a special tax for Calabria in addition to the normal company tax was held to be constitutional only where this tax was collected through the Rolls and not by self-assessment.

Another case is that which concerned the different rules for the deduction of interest paid when calculating business income. Other cases concern the constitutionality of the discrimination which was the result of the non-deductibility of compensation paid to unregistered third parties (No. 201 of 1970), and of the prohibition against the reimbursement of the purchase tax paid through stamps (No. 88 of 1971).

The second group of judgments concerned issues which more directly questioned the merit of the ordinary legislature's choices. In these cases the Constitutional Court refrained from considering the issue in depth, and recognised the full constitutionality of different tax treatment for situations which were potentially comparable from the point of view of the capacity to contribute.

In this context, these judgments are significant: No. 197 of 1975 where the special tax on luxury buildings was declared constitutional (although this meant heavier taxation of income from luxury buildings even though this income was of the same nature and the same amount as income from any other buildings); No. 81 of 1966 where the constitutionality was upheld of the old duty on dividends on dividends received by taxpayers who were exempt from the tax on companies (notwithstanding that this involved discrimination between such persons with regard to the kind of income received); and most importantly, No. 147 of 1975 where the legitimacy of the so-called tax on the aggregate amount of a dead person's estate was recognised. In this last case, in particular, there is no doubt but that in similar situations, because of the progressive taxation of the aggregate amount of the estate, the sole heir of an estate worth 100 had a lesser tax burden than two heirs (considered separately) of an estate the total value of which was 200. However, this touched upon a problem which had been much discussed in both academic and political circles: the Court substantially thought (in the author's opinion, correctly) that it should not interfere with the solution of this problem.

Finally, the third group of decisions is constituted by those where, in the name of equality of treatment, the Court made itself the spokesman for various requests for substantial justice.

Reference is made to the recent and important judgments where the Constitutional Court held to be unconstitutional:

(a) the rules which for the purpose of the personal income tax (Decree No. 597 of 29 September 1973) established the so-called aggregation of the income of spouses who were not separated in both fact and law (Constitutional Court, 14 July 1976, No. 179);

(b) the rules relating to the municipal tax on increases in the value of land (Decree No. 643, 26 October 1972) which, although they subjected to tax gains accrued during a long period of time (as much as 17 years), did not provide adequate corrective measures to deal with the fact that the gains taxed were accrued over different periods of time so that there was no way of avoiding the obviously unjust consequences which could result, in the long term, from inflation.

(c) the rules concerning the local income tax (Decree No. 599 of 29 September 1973) which excluded from the scope of the tax employment income, but not income from self-employment, even though this income was not to be considered as business income (Constitutional Court, 26 March 1980, No. 42).

8. CONCLUSION

This review, even though it is merely a bird's eye view, of numerous decisions by the Constitutional Court demonstrates the importance which Art. 53 has acquired, and how far we have come since it was anticipated, with subtle intuition, that "it can well be said that Art. 53 synthesizes the main principles and fundamental contours of the entire tax system (F. Forte, "Notes on Italian constitutional tax rules" responding to Benvenuto Griziotti's contributions to fiscal law, *Jus,* 1957, 372 et seq.).

What is more, someone struck by the frequency of constitutional arguments in tax cases even said that we have come too far. In fact, by now, of the questions submitted to the scrutiny of the Constitutional Court, questions concerning tax law are clearly in the majority (relatively speaking, of course).

The orders for referral to the Constitutional Court regularly follow each other; there are several (particularly those of the Tax Commissions) each year. Obviously they bring up questions which concern not only Art. 53, but also (only the most important subjects are noted) the constitutional principle concerning the exclusive competence with regard to taxation of the legislature (Art. 23 of the Constitution), allegedly *ultra vires* actions by the legislature (Art. 76 of the Constitution), and the regional tax laws. (During 1982 alone, the author published 93 orders for referral to the Constitutional Court in his periodical review.)

There is no doubt that this phenomenon merits a great deal of attention, because only from the responsible exercise of the instrument which serves to ensure that the laws passed are constitutional can that instrument's purpose be achieved, namely, the ever fuller realisation of the constitutional design. However, it is just as true that one must beware of conclusions which are hasty, generalised, and ill-considered.

In the first place, one can not forget that "the system of control as to constitutionality adopted in Italy requires a real and harmonious collaboration between ordinary and special judges and the Constitutinonal Court in order to safeguard the certainty of the law and the effective protection of the situations which are constitutionally guaranteed" (see Crisafulli, "The Constitutional Court between the Bench and Parliament", in *Juridical writings in memory of P. Calamandrei,* Padova, 1957, IV, 273 et seq. et spec. 293).

As Piero Calamandrei himself wrote 27 years ago ("The Constitutional Court and Judicial Authority", in *Rivista di diritto processuale*, 1956, 7 et seq.:

> it is not sufficient that between the Constitutional Court and the judges, whether ordinary or special, there exists only that purely negative respect as to the exact limits of their competence, which is based on the division of powers which all public organs are bound to observe; for the control of the constitutional legitimacy of laws to have a prac-

tical effect through the rather singular system adopted by the Constitution something more is necessary: real and active collaboration between the Constitutional Court and the judges who, when carrying out this delicate function, should appear to be complementary and inseparable instruments within a single mechanism for litigation . . . .

It might be thought that according to this system, the judicial authority is the servant of the Constitutional Court for which it investigates, examines and chooses which questions of constitutional legitimacy are worthy of being brought to the attention of the Court.

On the other hand, it could also be said that the Constitutional Court is at the mercy of the judicial authority because citizens cannot reach the Constitutional Court except, when there is a case which concerns them individually, by passing through the door constituted by the judicial authority – if the judicial authority does not open that door there is no other way to reach the Constitutional Court.

The alleged "activism" of the Tax Commissions in bringing up questions concerning the Constitution should therefore be judged in the light of the authoritative teaching according to which:

(a) each time the interpretation of an ordinary law is not consistent with the Constitution one must call for intervention by the Constitutional Court (G. Conso – today a judge of the Constitutional Court – "The certainty of the law: yesterday, today, tomorrow", in *Riv.dir.proc.*, 1970, 547);

(b) the rule which entrusts the judges with the decision as to whether a submission of unconstitutionality which is manifestly groundless is violated "both when the submission of unconstitutionality is declared to be prima facie manifestly groundless simply in order to take the question out of the Constitutional Court's cognizance, and when the decision as to soundness of the submission gives rise to, as sometimes happens, a considered judgment of groundlessness which certainly exceeds (like a considered judgment that there were grounds) the powers which the legal system confers upon the judges" (F. Bonifacio – past President of the Constitutional Court – "The Constitutional Court and the Judicial Authorities", *Riv.dir.proc.*, 1967, 254);

(c) "to exclude the manifest groundlessness of the objection . . . it is sufficient to note that both submissions of unconstitutionality are supported by serious theoretical arguments" (Court of Cassation, Section one, ord. 23 December 1974, No. 530 in *Giustizia civile*, 1975, III, 78).

From this point of view, even if some of the cases concerning the constitutionality of tax rules could have been avoided through more profound and responsible use of the normal interpretative criteria (for their characterization see the author's periodical review of constitutional questions), one should not forget that many of the questions put forward by the Tax Commissions were the reflection of attentive and intelligent study of theoretical contributions which, like the doubts in case law (practice and theory), then found authoritative support in the Constitutional Court; for example (mentioning only the most important and recent cases), the judgments concerning INVIM (No. 126 of 1976), the aggregation of spouses' income (No. 179 of 1970), the application of ILOR[3] to self-employment (No. 42 of 1980), and the non-deductibility of medical expenses incurred abroad (No. 142 of 1982).

Furthermore, and finally, one certainly cannot forget that the way in which the legislative power is (or is not) exercised dialectically affects the alleged excess of constitutional cases.

This is true from at least two points of view.

On the one hand, the ever-present urgent necessity of finding new tax revenue to cope with public expenditure, which grows continuously, is matched by a normative "corpus" which by now has become quite imposing (see the facts given by, and the conclusions of, A. Berliri, "On the causes of the incertainty as to the characterization and interpretation of the tax laws applicable to a particular factual situation", *Diritto e Pratica Tributaria*, 1979, I, 30-47), and which has lost, and continues to lose at an ever increasing rate, system, harmony and conformity with its principles, and which has caused an extremely alarming increase in litigation (see the short and effective synthesis by the ex-Minister of Finance, F. Reviglio, "The state of tax litigation", *IVI*, 1177-1181). Therefore, the particular frequency with which doubts emerge about the actual alignment of ordinary laws with constitutional principles represents one aspect (which is to a certain extent inherent or physiological) of the system.

It is the institutional task of the judge to give these doubts his attention, to consider their relevance and whether or not they are manifestly groundless, and to submit suitable questions to the scrutiny of the Constitutional Court.

On the other hand, one cannot ignore both the deafness of the legislature when understanding and eliminating in time important inconsistencies in the normative order, and the legislature's unjustifiable inertia in front of the Constitutional Court's precise suggestions which, were they followed, would avoid the growth of further litigation.

To be convinced of this, it is sufficient to look at two important questions submitted to the scrutiny of the Constitutional Court (and decided by the Court) by several orders for referral.

In 1975 Parliament rejected the proposal of the then Minister of Finance (B. Visentini) to exclude income from self-employment from the ambit of the local income tax; the reasons which the Minister gave then (see G. Marongiu, "The qualitative discrimination with regard to earned income as examined by the Constitutional Court", *Diritto e Pratica Tributaria*, 1978, I, 505-597) are to a large extent taken up in the judgment of the Constitutional Court (No. 42 of 1980) already noted.

Similarly, Parliament ignored the unequivocal and authoritative warning not to tackle with levity the delicate problem as to the choice of subject of the progressive income tax on individual persons, thus earning the criticism of the Constitutional Court (Judgment No. 179 of 1976).

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3. Imposta locale sui redditi (local income tax).

Moreover, today Parliament obstinately disregards the Constitutional Court's suggestions (in Judgment No. 179): "The Court hopes that on the basis of income tax declarations completed by spouses and in a system arranged in accordance with separate taxation of one's respective aggregate income, spouses may be given the opportunity to opt for a different system of taxation (expressed in one way only or shaped into more ways) which would facilitate the formation and development of the family, and take into account both the housewife and working woman". In other words, Parliament has for years been pretending to ignore (this expression is used because the danger of inequality arises again, and the way to avoid that danger is pointed out in Senator Segnana's useful report prepared in 1977 for the Senate's Permanent Commission on Finances and the Treasury) that Law No. 114 of 13 April 1977, which introduced the separate taxation of spouses, far from being an arrival-point, is simply a halt along the way.

The unrelenting ordinances from the Tax Commissions which invest the Constitutional Court with new questions of constitutional legitimacy correspond with the sloth of Parliament.

In conclusion, the tax legislature must understand that the original framers of the Constitution intended that the constitutional principles contained in Art. 53 be referred to the tax system.

This last principle undoubtedly expresses the rejection of a system of rules which are enacted by chance, which are dictated without having been properly considered, which are the fruit of breathless nocturnal sessions of Parliament which are renewed daily just like newspapers but which, unlike the newspapers, risk finding readers who are ever less interested and juridical operators who are less diligent.

I think that this principle is so explicit and unequivocal that it can easily be understood by all, especially those who daily refer to the values contained in the Constitution.

[Continued from p. 413]

Indeed, Circular 9/2267 states that "on the fairness of the compensation provided for, various factors should be taken into account:

(a) cost-sharing between the various affiliates;
(b) the method of sharing utilized for the Italian affiliate;
(c) the method of sharing utilized for other affiliates;
(d) the relevance of the sales only to the productive activities to which the service rendered refers;
(e) the inclusion or omission of the consideration of the service in the price of the goods transferred to the Italian affiliate by the foreign controlling company or by other affiliates (in particular, when the cost-plus method is used for the determination of the value of the goods purchased);
(f) the effective use of the service by the Italian affiliate;
(g) the actual impact of the service on the reduction of costs for the Italian affiliate;
(h) the ratio between the net income for the period, the reduction of costs related to the service rendered and the consideration paid;
(i) the long-term advantages obtained by the affiliate from the service rendered;
(j) the approximate comparison between the fees received by the foreign company and the approximate cost of the service;
(k) the profit margin for the foreign company (for services included in the institutional activity of the rendering company);
(l) similar services rendered to other independent undertakings;
(m) services rendered between independent undertakings;
(n) the actual performance of the service by the controlling entity or the mere intermediary between the recipient affiliate and an independent company.

Consideration of the above factors highlights the necessity and importance of having access to the cost-sharing agreements contracted by other group entities.

Le secret bancaire en Italie à l'égard du fisc après la réforme de 1982

Par Furio Bosello

Dans le droit italien, le secret bancaire n'a aucune définition légale. Il est reconnu par la jurisprudence et la doctrine: mais c'est bien la loi fiscale, en introduisant des dérogations au profit du fisc, qui en a fait, elle seule, l'objet d'une disposition législative.

Il faut tout d'abord dire qu'en droit italien la source du secret bancaire est dans le droit coutumier; et que d'après la doctrine, il ne s'agit pas d'un véritable secret professionnel: mais le fait important est que la loi fiscale, en le prévoyant, confirme l'existence du secret lui-même.

Celui-ci consiste, du moins pour le droit italien, dans le devoir, pour la banque, de ne pas révéler les rapports qu'elle entretient avec ses clients et, en général, avec tous ceux qui s'adressent à la banque même. C'est une obligation de discrétion, à laquelle le banquier est tenu, en raison de son activité.

Jusqu'en 1971 la loi fiscale ne s'occupait pas du secret bancaire. Ce fut par la loi de délégation pour la réforme fiscale que le secret bancaire a été prévu, pour la première fois par la loi.

L'Art. 35 du D.P.R. du 29 septembre 1973, no. 600 a réglé les cas de dérogation au secret, pour les impôts directs seulement, en autorisant l'Administration Fiscale, après une rigoureuse procédure, à demander aux banques des renseignements concernant les rapports avec les clients.

Le système a été reformé en 1982, par le D.P.R. du 15 juillet 1982, no. 463, qui a augmenté les pouvoirs de l'Administration en matière de dérogation au secret bancaire.

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La dérogation au secret est seulement prévue pour les impôts directs et pour l'I.V.A. (impôt sur la valeur ajoutée). Par conséquent, l'Administration ne peut pas demander aux banques des renseignements en ce qui concerne d'autres impôts, ni utiliser les données ainsi obtenues pour des impôts différents.

En outre, il faut souligner que la dérogation n'est pas une dérogation *totale:* c'est à dire qu'il y a des rapports bancaires qui restent toujours couverts par le secret.

La loi, en effet, ne prévoit la dérogation que pour les "comptes" qui sont passés entre la banque et le client: voilà pourquoi on a considéré que, par exemple, les coffres sont exclus.

La dérogation peut être disposée soit pour les contribuables personnes physiques soit pour les sociétés, etc. Si le contribuable est une personne physique, la dérogation peut aussi concerner sa femme (ou son mari) et ses enfants mineurs: on ne comprend pas bien la raison de cette dernière disposition.

La dérogation au secret ne peut être obtenue par l'Administration que dans les cas prévus à des fins fiscales par la loi, et qui sont presque les mêmes en matière d'impôts directs et de I.V.A.

Les élements qui permettent la dérogation sont des éléments indicatifs d'une évasion de haut niveau ou d'un remarquable danger fiscal: par exemple lorsque la déclaration des revenus ou de l'I.V.A. n'a pas été présentée alors que le contribuable, au cours de la période considérée, a eu des recettes de cent millions au moins, ou bien que la comptabilité n'a pas été tenue, etc. On peut bien dire qu'il faut que le contribuable ait caché des affaires dont le montant est élevé pour qu'une dérogation au secret soit applicable ou qu'il ait fait des violations remarquables à ses devoirs fiscaux.

La procédure pour la dérogation est très rigoureuse.

L'Administration, ou mieux le Bureau fiscal, après avoir constaté l'existence des éléments qui permettent la dérogation, doit d'abord obtenir la permission du Bureau supérieur (l'Inspecteur) ainsi que l'autorisation du Président de la Commission fiscale (qui est le juge spécial en matière fiscale). La dérogation peut être aussi requise par la "Guardia di Finanza", c'est à dire un corps de l'armée qui s'occupe (curieux, mais vrai) d'affaires fiscales.

La banque a le devoir de donner les renseignements demandés par le fisc, en fournissant toutes les données.

Mais la dérogation concerne seulement le sujet pour qui elle a été demandée: voilà pourquoi la banque ne peut jamais faire connaître des renseignements concernant des *tiers* (et l'Administration ne peut le demander).

Si la banque ne réponds pas ou si sa réponse n'est pas satisfaisante, l'Administration peut demander l'accès des fonctionnaires (ou de la "Guardia di Finanza") auprès de la banque. Ce pouvoir a été reconnu pour la première fois par la loi de 1982. Cela a fait beaucoup de bruit en Italie et cette disposition a été très critiquée.

Le pouvoir d'accès auprès des banques est une des nouveautés introduites par la loi de 1982. L'autre est constituée par le pouvoir de l'Administration, d'utiliser les données acquises par la "Guardia di Finanza" au cours de son activité en tant que Police Judiciaire. On sait qu'il y a trois corps qui peuvent être utilisés pour les services de Police Judiciaire, en Italie: Pubblica Sicurezza, Carabinieri et Guardia di Finanza. Si le Magistrat pénal, pendant une enquête pénale, emploie la "Guardia di Finanza" (comme police judiciaire) celle ci, après avoir obtenu la permission du Magistrat, peut utiliser les données au profit du fisc. Cette disposition a été critiquée, par la doctrine, plus encore que celle concernant les accès.

Il faut rappeler que, d'après la loi de délégation, la dérogation peut avoir lieu seulement à des fins fiscales: un procès pénal ne semble pas avoir ce caractère. En outre, on ne comprend pas la raison de permettre la dérogation au profit du fisc si l'activité de Police Judiciaire est faite par la "Guardia di Finanza" au lieu, par exemple, des Carabinieri. On soupçonne que cette règle soit contraire à la Constitution.

On peut dire, qu'à present le secret bancaire, en Italie, est très faible à l'égard du fisc, mais on peut aussi dire qu'il existe encore. La réforme de 1982 a changé beaucoup de choses: mais il s'agit d'une loi qui est en vigueur depuis peu de temps et il n'est donc pas facile d'en donner un jugement avant de voir comment elle sera appliquée.

Tax Law and Exchange Control in the Republic of San Marino

By Adriano di Pietro

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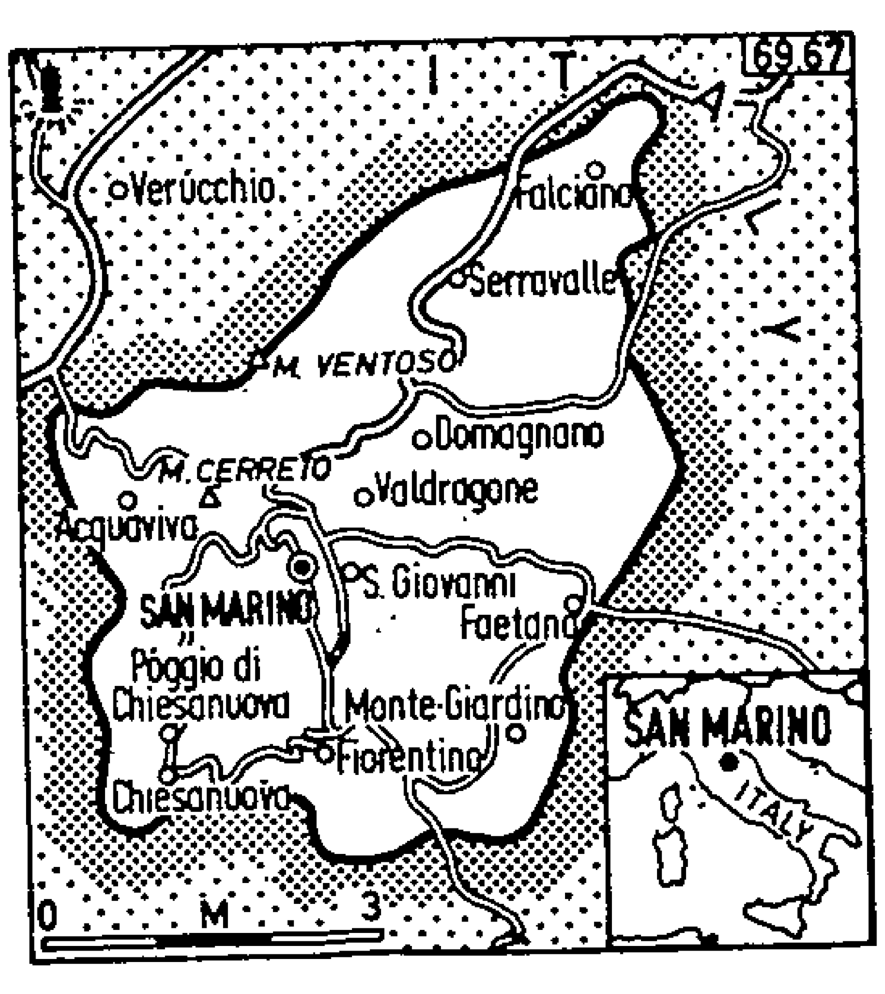
I. TAX LAW

A. General

The tax system which exists today in San Marino is not the fruit of a single coherent fiscal provision; it is the result of successive provisions creating a legislative complex which today looks like a complete and organic whole, although it was not enacted as a normative entity.

The Italian tax system certainly influenced the Sanmarinese system, as can be seen from the Sanmarinese income and transfer taxes. This can be interpreted as the manifestation of a tendency in the formation of the Sanmarinese tax system to look for and achieve a high level of coherence with the Italian system on account of both San Marino's particular geographical position, and its relations with Italy as governed by the 1939 treaty.

However, simply noting the existence of Italian influence and characterizing the tendency described above does not amount to declaring that the Sanmarinese tax system does not possess areas of autonomous fiscal regulation and is homogeneous with the Italian one. Thus it is true that not only does the structure itself of the Sanmarinese republic not permit, in a general review, any distinction between state taxes and local taxes, but also sectors remain where the difference from the Italian system is evident, e.g. the tax on internal trade and on real estate, and the fiscal levy on manufacturing.



B. Income taxes

The influence of the Italian system (as it was prior to its reform) is evident in the variety of taxes, in the way in which the taxes are connected and in their juridical structure.

1. Normal income tax

Here we are concerned with a "real" tax which is articulated according to different categories of income, each of which is distinguished by its source and by the criteria for the determination of taxable income.

Firstly, Art. 3 of Law No. 10 of 16 March 1922 sets out 6 different kinds of income: income from every kind of investment except income from land or buildings (category I); income derived from capital invested in buildings (category II); income derived from capital invested in land (category III); income resulting from the concurrent use of capital and labour (category IV); income derived from labour (category V); and income derived from manual labour (category VI). This last category has been suspended since the enactment of this law.

Then different criteria are applied, namely: for categories I, IV and V, both real and presumed income is taxed; whereas categories II and III are subject to cadastral assessment.

Finally, for the first three categories the levy applies to the entire income, whereas for the other categories it applies only after the deduction of different allowances so as to realise a qualitative discrimination between different kinds of income, the rate of taxation being fixed at 8%. The rate on category IV income is 6%, on category V income 4% and on category VI income 2%.

All subjects (both natural and legal persons) who are resident or domiciled or who have their seat in San Marino are taxable (Art. 1). However, there is one noteworhty difference between the different kinds of subject which concerns the mode of taxation: companies, provided that they are recognised as such, are taxed by reference to their profits which are calculated on the basis of their profit and loss account (Law No. 22 of 4 May 1977).

2. Supplementary income tax

This is a progressive personal tax (the rate varies from 0.40 to 7%), applicable to the taxpayer's total income, which is generally calculated according to the rules for the normal income tax. In fact, this tax applies to anyone who possesses or enjoys in the Republic of San Marino total taxable income which is not less than the minimum income which is taxable for the purpose of the normal income tax.

No distinction is made between natural and legal persons; nor is a distinction made between Sanmarinese citizens and foreigners in that this tax also applies to income produced outside San Marino but enjoyed within San Marino by either Sanmarinese citizens or foreigners who are resident in San Marino (Art. 20, Law No. 10 of 16 March 1922). The fourth paragraph of Art. 20 provides for recourse to a presumptive assessment in the absence of positive information.

3. Tax on income from land and buildings owned by companies, partnerships and entities which operate without a profit motive

This tax (which was introduced by Law No. 12 of 29 March 1943) is applied at a rate of 3% to income (which is calculated cadastrally) from land and buildings owned by companies, partnerships, and entities which operate without a profit motive, so it can be described as applying in the same way as an income tax. However, this tax's annual application excludes the possibility of any transfer taxes in any case where the taxpayer subsequently transfers ownership of the land or buildings. Therefore, the function of this tax can also be described as acting as a substitute for the transfer tax.

C. Indirect taxes

1. Registration tax

According to Art. 1 of Law No. 11 of 14 March 1918, this tax applies to all public and private deeds, including judgements and arbitration decisions handed down by judicial authorities, and reports of judicial auctions.

Although the law is silent with regard to this question, it is thought that only those deeds which were written or executed within the territory of San Marino are subject to the registration requirements. The only exception concerns deeds drawn up abroad when they contain the transfer of real estate or rights in land which is located within the territory of the Republic of San Marino.

The tax is linked to the formality of registration (which must be effected within 30 days – Art. 55) and is applied as a progressive, proportional or fixed rate tax according to the different kinds of deed. For instance, with respect to transfer of real property the rate is 3% and with respect to movable property 2%.

2. Estate tax

The new formulation of this tax (Law No. 84 of 29 October 1981) specifies its scope, stating that it applies to every transfer of property, usufruct or enjoyment of goods or rights which takes place as the result of the death of any person (Art. 1). The law also provides that the taxable base is the amount by which the value of the estate of the heir or legatee is increased, and lays down the criteria for the computation of that amount (Art. 2). The tax is progressive (there are different tax brackets) and applies to the deceased's net estate; the heirs or legatees are liable for this tax and are therefore obliged to present the appropriate tax return indicating the value of the estate (Art. 24).

3. Stamp tax

Stamp tax applies to civil, administrative, public, private and judicial deeds, to documents produced as evidence in judicial proceedings, to documents which are attached to public deeds, to tax returns relating to the estate of a deceased person, and to the registers and certain other documents expressly mentioned in the law (Art. 1 of Law No. 86 of 29 October 1981). The tax is paid in a "normal, extraordinary or virtual" way (Art. 2), that is to say, the tax is paid through the use of pre-stamped paper, or by stamping each deed individually, or by payment directly to the tax office without actually stamping the deeds.

4. "Cinquina" tax

The tax is additional to that imposed by the registration and estate taxes; in fact it applies (Art. 5 of the Registration Tax Law, and Art. 1 of the Estate Tax Law) to transfers of land inter vivos (rate 10%) or mortis causa (rate 5%) in favour of foreigners, and the taxable base is that laid down for the registration and estate taxes. The tax applies to natural and legal persons, including companies the share capital of which is held by foreigners (Art. 9 of the Law No. 45 of 21 December 1942).

D. Tax on imports

This tax applies to goods and related services imported into Sanmarinese territory (Art. 2 of Law No. 40 of 22 December 1972); in particular, to the total value of the consideration due (Art. 3). The rate is normally 7% but special rates apply to certain goods. The persons who are liable for the tax are the subjects who effect the importation, with joint and several liability on the part of the subjects on behalf of whom the importation takes place, and those who physically import the goods (Art. 5). The tax is collected by the tax office through the use of the appropriate stamps (Art. 8). However, the tax is refunded when the goods, after being processed in some way, are re-exported (second paragraph of Art. 1); the mode of refund differs according to whether the re-exportation is to Italy, or to other countries.

As for the application of Italian taxes to foreign goods destined for San Marino, these goods are subject to customs duties and are cleared through Italian customs just like any other foreign goods entering the territory of Italy, whereas value added tax is paid to the Customs who hold it in deposit and reimburse it to the Republic after the goods enter the Sanmarinese Republic (Art. 71 of Italian Decree No. 633 of 26 October 1971); the mode of reimbursement is that provided for by the decree of the Italian Minister of Finance of 29 December 1972.

Finally, it should not be forgotten that the import rules also affect Italian economic operators: the transfer of goods by delivery or consignment to the Sanmarinese republic is treated, for the purpose of value added tax, as exportation of the goods (Art. 71, Decree No. 633); the introduction into Italy of goods originating in San Marino is, exceptionally, deemed to be effected within Italy by a non-resident subject so that the value added tax is owed by the Italian transferee (second paragraph of Art. 71).

E. Minor taxes

The tax on mortgages (Law No. 83 of 29 October 1981), the special tax on petroleum products (Art. 4, Italo-Sanmarinese Convention, 1974), the tax on the occupation of public areas, the tax on radios and television sets, the tax on licenses for the conduct of commerce and industry, the tax on hunting licenses, the scholastic tax, the tax on government concessions, and the social security levy (Law No. 42 of 22 December 1955) should all be noted.

F. Sanctions and litigation

The Legal Commissioner prescribes the administrative sanctions which are provided for illegal acts relating to the application of the taxes described above. This Commissioner is competent to deal with tax controversies, even though recourse to a particular commission (called the commission for the fairness of values) is provided for disputes relating simply to valuation with regard to the transfer of land.

II. EXCHANGE CONTROL

The enclave nature of San Marino can justify the absence of regulation of the movement of capital between Sanmarinese residents and Italy and between Italy and other states. However, in the latter case Italian law is relevant as it applies the same rules provided for Italian citizens to Sanmarinese residents.

For the resident Italian there is the problem of the application of the Italian exchange control rules to operations carried out in Sanmarinese territory. Two factors suggest that the Italian exchange control rules should be applied: the recognition of San Marino's territorial sovereignty, and the customs border (which was already in existence before the new tax on imports was enacted, and was confirmed by the new tax rules which also concern the application of value added tax – see above).

It should not, however, be forgotten that relations between the states are regulated by the special Convention of 1939 which affirms the principle of free movement of goods and persons; a principle which must be held to be applicable to those sectors, like that relating to capital, where – unlike the case of trade – no specific system exists. This principle acquires further importance in view of the absence of Sanmarinese exchange control rules, and the enclave nature of San Marino. In this case the non-application of Italian rules would simply be the consequence of the existing monetary union between Italy and San Marino.

III. SANMARINESE LEGISLATIVE SOURCES

Law No. 11 of 14 March 1918 (registration tax law).
Law No. 10 of 16 March 1922.
Law No. 12 of 29 March 1943 (law relating to the tax on income from land and buildings owned by companies, partnerships, and entities which operate without a profit motive).
Law No. 45 of 21 December 1942 (law on partnerships, companies and direct taxes).
Law No. 42 of 22 December 1955 (law on the social security tax).
Law No. 40 of 22 December 1972 (measures concerning and modifications to tax law).
Law No. 22 of 4 May 1977 (law amending Law No. 10 of 16 March 1922, and Law No. 45 of 21 December 1942).
Law No. 84 of 29 October 1981 (law on estate tax).
Law No. 86 of 29 October 1981 (law on stamp tax).

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Espagne: Evasion, Evitement et Fraude en Matière Fiscale

Par Eusebio González

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Il a publié les ouvrages suivants:
1. Introducción al Derecho Presupuestario, Madrid, (1973); 2. Curso de Derecho Tributario, vol. I, 2è ed, Madrid, (1978); 3. Curso de Derecho Tributario, vol. II, 3è ed, Madrid, (1980); et il a écrit des essais dans un grand nombre de livres collectifs:
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1. INTRODUCTION

La première difficulté qui surgit à l'instant d'aborder le thème polémique soumis à la considération des participants du 37è Congrès de l'IFA provient du fait qu'il faut connaître avec exactitude, en premier lieu, quels sont les concepts ou idées que nous allons manipuler; et tout de suite après, essayer de donner des noms ou coller des étiquettes aux concepts en question, car si non, la confusion pourrait atteindre un caractère babylonien.[1]

Du point de vue de cette perspective générale et sans pouvoir toutefois mettre une étiquette sur les divers concepts, conformément au précepte fiscal qui impose une certaine obligation fiscale, nous devons souligner trois procédures ou conduites:

a) Celle qui, pour ne pas payer l'impôt en question, abandonne l'activité imposée ou cesse de consommer.
b) Celle qui cache une partie ou tous les faits ou actes qui sont à l'origine de la contribution.
c) Celle qui choisit d'autres voies, moins ou pas du tout imposées, afin d'obtenir un résultat économique équivalent à celui que la loi pensait imposer. Dans cette alternative, il faut encore considérér deux modalités:
   (i) Celle qui, agissant de la façon indiquée, ne se soumet qu'en apparence au règlement fiscal, attendu qu'en réalité, elle porte préjudice à la ratio legis du précepte.
   (ii) Celle qui, agissant de la façon indiquée, n'entre en collision avec aucun des préceptes fiscaux concrets, n'optant que pour la voie la moins imposée.

Si nous considérons ces trois modes de procédure, nous ne croyons pas devoir insister sur le fait que le premier reste en dehors des limites de ce Rapport, attendu que lorsque l'on cesse de produire, échanger ou consommer les objets imposées, nous ne pouvons parler d'évasion puisque l'on ne se trouve pas à l'intérieur de ce concept, il n'y a pas non plus d'évitement, car l'on ne recherche pas l'obtention du fait économique imposé et encore moins de fraude, attendu qu'il n'y a nullement duperie.

La deuxième procédure qui représente, c'est un fait, une forme d'évasion et qui pourrait donner lieu, suivant les modalités utilisées, à une activité frauduleuse, ne présente pas, en raison de la clarté de l'illégalité de la conduite, d'intérêt spécial pour ce rapport.

Le véritable problème surgit dans le cas de la troisième procédure où apparaît la grande difficulté, précisément, lorsqu'il s'agit de séparer les deux sous-espèces que nous avons établies. Ainsi, le problème devient plus ardu et par conséquent, plus intéressant, si nous observons que la deuxième sous-espèce dont il a été question dans la troisième procédure, est si légitime qu'il est inutile de préciser plus clairement ses contours juridiques. Par contre, la première d'entre elles qui, suivant la logique juridique, devrait être qualifiée de contraire à la loi, présente tant de nuances et de difficultés lorsqu'il faut faire ressortir sa véritable nature, que nous considérons qu'elle doit constituer le noyau d'un rapport qui prétend se déplacer entre l'évasion, l'évitement et la fraude.

1. Nous avons eu l'occasion de prendre position sur cette question une première fois dans le Rapport National Espagnol sur le sujet I ("la evasión fiscal legitima") des IV Journées Hispano-luso-américaines d'Etudes Fiscales célébrées à Estoril (Portugal) en 1970, contenue dans la revue portugaise Ciencia e Tecnica Fiscal, no. 144 et dans la Mem. Asoc. Esp. Der. Fin., correspondant à 1970. Une traduction corrigée a été insérée postérieurement dans la Riv. Dir. Fin. Sc. Fin., 1974.

Après avoir brossé en grandes lignes le schéma du rapport suivant les termes exposés, je peux indiquer que j'ai des doutes en ce qui concerne nos possibilités d'arriver à une conclusion définitive (c'est-à-dire, une solution unique du problème), à moins que nous ne possédions tous une même conception de la loi et de ses méthodes d'interprétation. Que ce soit avant où après, il arrivera un moment où il faudra que nous examinions le problème fondamental pour lequel chacun de nous aura tendance à se prononcer pour une conception en faveur du fond ou de la forme de la loi.

II. PROPOSITION D'UNITE DE TERMINOLOGIE

Avant de commencer à exposer pour quelles raisons nous avons choisi telle ou telle expression pour désigner un précepte déterminé, nous devons revoir la terminologie variée et confuse que nous offre la doctrine et la législation contemporaines. Nous ferons pour l'une et l'autre la distinction entre nationale et étrangère et pour cette dernière, nous verrons comment le problème s'amplifie par suite des traductions.

Dans la législation espagnole, le problème suscité par le paragraphe 2 de l'art. 24 de la Loi Générale Fiscale[2] où les concepts de fraude à la loi, l'évitement et économie d'option sont mêlés et confondus et ne présentent pas tellement d'originalité. Aussi, au lieu d'examiner ce fait sur notre terrain, il semble plus naturel de nous reporter à la législation et doctrine germaniques, berceau du sujet qui nous intéresse.

Nous savons que le paragraphe 10 de la Reichsabgabeordnung, axe et source de nos préoccupations actuelles, disposait:

1. Les devoirs fiscaux ne peuvent être éludés ou réduits au moyen de l'abus des formes et des possibilités d'adaptation au Droit Civil.
2. Il existe abus de formes conformément au paragraphe antérieur, si: 1°. dans les cas où la loi soumet à contribution des évènements, faits ou relations économiques dans leur forme juridique correspondante, l'on choisit des formes juridiques ou l'on réalise des affaires juridiques insolites, c'est-à-dire qui ne correspondent pas aux faits ou relations économiques, afin d'éviter l'impôt et 2°. compte tenu de la nature des relations et de la façon d'agir, les parties obtiennent des résultats à peu près identiques à ceux découlant de la forme juridique adéquate et, de plus, 3°. les inconvénients juridiques provenant de la voie adoptée n'ont en réalité aucune importance ou sont minimes.
3. S'il y a abus, les moyens adoptés n'ont aucune importance en ce qui concerne la contribution. Les impôts doivent être perçus de la même façon que si les évènements, faits ou relations économiques avaient revêtu la forme juridique appropriée. Les impôts payés sur la base de procédures inefficaces seront retournés sur demande préalable s'il existe un jugement en faveur de telle sollicitude.[3]

HENSEL[4] indique en commentant ce précepte qu'il contient une supposition subrogatoire de caractère général afin de lutter contre la figure juridique l'évitement[5] incluse – dans le secteur plus ample des conduites frauduleuses à la loi."[6] Mais quelques pages plus avant (pag. 142 et suivantes), ce même auteur avait développé l'idée que la technique des suppositions subrogatoires offrent peu d'emprise pour combattre l'évitement en raison de l'impossibilité de tout prévoir. Il s'en suit donc que "cette raison (poursuit HENSEL), ajoutée aux motifs moraux qui conseillent de séparer l'évasion fiscale sous toutes ses formes, nous a contraint à introduire la clause générale du paragraphe 10 de l'A.O. qui tend à combattre l'évitement". Il en resulte donc que l'évitement est un concept compris autant dans la fraude à la loi que dans l'évasion. Reste à savoir si ces deux derniers concepts sont indépendants ou si l'un d'eux se trouve compris dans l'autre.

Le problème se complique encore plus lorsque HENSEL affirme qu'au moyen de l'impôt l'on n'essaie pas (comme il en est de la fraude fiscale) de violer une loi impérative, attendu qu'aucune loi fiscale interdit la possible obtention de résultats économiques par une voie différente de celle établie par le législateur, mais il n'en reste pas moins, toujours suivant HENSEL, que l'évitement sert a cacher la fraude. Et de conclure "malgré les dangers provenant d'une clause aussi générale que celle du paragraphe 10 de l'A.O., ce règlement représente une arme efficace pour combattre la fraude fiscale".

Le panorama décrit acquiert de nouveaux traits lorsque, abandonnant le secteur des concepts, nous observons les termes utilisés par les diverses traductions. Ainsi, par exemple, si nous considérons le premier paragraphe du paragraphe 392 de l'A.O., GIORGETTI appelle "évasion fiscale" ce que JARACH désigne sous le nomme de "délit fiscale".[7] Mais pour le premier alinéa du paragraphe 396 de l'A.O., GIORGETTI appelle "évasion fiscale" ce que JARACH nomme "fraude fiscale".[8] En ce qui concerne le paragraphe 396 de ce même texte légal, GIORGETTI indique que l'évitement des devoirs

2. "Pour éviter la fraude à la loi, en ce qui concerne les effets du numéro précédent il est établi qu'il n'existe pas d'ampliation du fait imposable lorsque l'on impose des activités réalisées dans l'intention prouvée d'éluder l'impôt, à condition que le résultat soit équivalent à celui provenant du fait imposable. Pour déclarer qu'il existe fraude à la loi, il faudra dresser un dossier spécial où l'Administration apportera la preuve correspondante et où l'intéressé aura droit d'audience".

3. Disposition qui figure dans le paragraphe six de la Steueranpassungsgesetz et aujourd'hui dans le paragraphe 42 A.O. 1976. L'influence de ce précepte sur les diverses législations fiscales est bien connue. L'article 244 du Code Général des Impôts français et l'art. 25 de la Loi Générale Fiscale espagnole en sont témoins.

4. Voir "Diritto Tributario", Giuffrè, 1956, pag. 148.

5. N'oublions pas que pour HENSEL, suivant en ce point Blumenstein, éluder se réfère toujours au fait imposable.

6. Il ne faut pas oublier à ce sujet que, conformément à Hensel, l'A.O. centre l'esquive dans l'abus des voies et des possibilités de configuration du droit civil, ce qui nous amène au problème de la distinction entre abus et non utilisation des voies prévues par le législateur. Cfr. notre ouvrage "La cosidetta evasione fiscale légittima", Riv. Dir. Fin., 1974, p. 70-71.

7. Nous devons aussi nous rappeler que pour Hensel, les délits fiscaux qui seuls peuvent dériver de l'accomplissement d'une obligation déjà née sont: la fraude fiscale, le danger pour l'impôt (risque de non paiement) et l'évitement (dans ses deux versions de camouflage de fraude fiscale et camouflage d'évitement).

8. Il nous semble que l'opinion de Giorgetti est fausse parce qu'il a traduit deux expressions allemandes différentes *(Steuervergehen* et *Steuerhinterziehung)* par le même mot, bien qu'un peu plus loin, il se corrige en traduisant, il nous semble correctement, cette fois-ci *Steuerhinterziehung* par "fraude fiscale".

fiscaux peut être sanctionnée ainsi que la fraude fiscale, mais uniquement lorsque la réduction des revenus fiscaux et l'obtention des bénéfices illicites correspondants sont dus à des manoeuvres du sujet pour se soustraire à ses devoirs fiscaux". Ainsi HENSEL (suivant la traduction de JARACH) considère qu'un acte de l'évitement fiscale . . . est masqué, auquel cas, et de façon objective, nous nous trouvons devant un délit de réduction fiscale (attendu que l'affaire se trouve encore soumise à contribution); mais, de façon subjective, celui qui élude ne se trouve pas dans l'obligation de respecter la loi, ainsi donc, le fait de masquer ne peut être considéré comme une réduction d'impôts". Et enfin, dans le paragraphe 402 de l'A.O., GIORGETTI a considéré que "la fraude fiscale est passible d'amende comme l'est le préjudice fiscal, uniquement lorsque la réduction injuste des revenus fiscaux . . . dépend d'une action du sujet, au moyen de laquelle il se soustrait intentionnellement ou par négligence à ses devoirs fiscaux". Tandis que HENSEL considère que "la fraude fiscale exige un comportement malhonnête à la source de l'action".[9]

Le problème soulevé par ce contraste des termes utilisés au moment d'interpréter les préceptes de l'A.O. en arrive à son point culminant lorsque l'on voit, à l'occasion des commentaires avancés par GIORGETTI pour le paragraphe 396 de l'A.O. que cet auteur identifie les concepts d'évitement et évasion légitime; tandis que pour BLUMENSTEIN, par exemple, l'évasion représente un fait susceptible de contribution[10], mais son évaluation exacte de la part de l'Administration se trouve gênée par le contribuable en raison de son comportement illégal[11] Ainsi donc, si nous comparons ces idées avec le concept de fraude fiscale de BRINDEL ("non accomplissement coupable de la prétention fiscale comme suite à la réalisation d'un fait imposable") et, supprimant les raisonnements intermédiaires, nous en arrivons à la conclusion, formellement irréprochable, mais contraire à la pensée des auteurs cités, qu'il existe une parfaite identité entre les concepts d'évitement, évasion et fraude fiscales.[12]

En évaluant les différentes interprétations et commentaires suscités par les précepts de l'A.O dont nous avons parlé, non seulement nous voyons apparaître les imprécisions de terminologie tant de fois citées, mais et ceci est beaucoup plus important, il peut sembler que nous parlons de choses différentes. Le panorama qui s'offre à l'interprète est, en synthèse, le suivant: BLUMENSTEIN et HENSEL parlent d'évitement du fait imposable sous la forme (que nous n'acceptons pas) qui nous est connue, mais ce concept est, à notre avis, franchement différent de la fraude à la loi[13]. De sorte que quand les uns et les autres nous prenons comme source commune le paragraphe 10 de l'A.O., quelqu'un doit se tromper. De plus, il est bon d'observer que le précepte en question n'est dirigé ni contre l'évitement ni contre la fraude à la loi, mais contre l'abus des formes juridiques.[14]

Tout compte fait, nous voyons, sans nul doute, que le concept d'évitement utilisé par cette doctrine ne s'entend pas avec celui d'abus des formes juridiques dont il est question dans le paragraphe 10 de l'A.O. et HENSEL n'a pas tout à fait tort lorsqu'il indique que ce précepte n'exprime pas clairement sa ratio legis, s'étant vue obligée d'admettre que "l'A.O. centre l'évitement dans l'abus des formes et les possibilités de configuration du Droit Civil". Et c'est là qu'a surgi le problème. Pour HENSEL qui s'occupe d'évitement, ce qui importe, ce n'est pas l'abus de certaines formes juridiques, mais la non utilisation des formes juridiques que le législateur considère typiquement aptes à l'obtention de certains effets. Pour l'A.O. qui considère "l'abus des formes et les possibilités de configuration du Droit Civil", ce qui importe, c'est de pouvoir prouver leur existence. Mais les deux positions convergent en un point, car bien souvent, la non utilisation des formes juridiques typiques pour obtenir certains effets conduit à un abus d'autres possibilités de configuration juridique.

De cette façon, nous croyons que le problème se trouve clairement posé, mais non pas résolu. A notre point de vue, ce second pas a pu être fait lorsque l'abus des formes juridiques a été extrait d'un secteur qui lui était quant au fond (non pour sa forme) étranger: celui de l'habitude des procédures juridiques utilisées, pour ensuite l'introduire dans le sien propre: celui de la dissension entre réalité économique et apparence juridique.[15]

Un exposé et une terminologie réellement différents de ceux utilisés par la technique allemande sont introduites par GIORGETTI, dans l'une des rares monographies

9. Nous croyons que Giorgetti n'a pas capté correctement le sens de ce précepte parce que, en premier lieu, il a traduit *Steuerumgehung* par "fraude fiscale", alors que peu avant (paragraphe 4 du 396) il avait traduit ce même mot par "évitement"; et deuxièmement, nous avons vu que cet auteur réserve l'expression "fraude fiscale" pour traduire *Steuerhinterziehung*.
Une observation analogue pourrait être faite pour le traducteur espagnol de l'A.O. 1931, qui ayant traduit, dans le premier paragraphe du 402 *Steuerverkürzung* par "réduction d'impôt", dans le paragraphe qui suit immédiatement, traduit ce même mot par "fraude fiscale".
Ces confusions terminologiques pourraient être répétées indéfiniment, si nous nous référons à la façon dont ont eté traduits les préceptes cités par R. Acosta, F. Forte, Giuliani Fonrouge, Sáinz de Bujanda, Scailteur et tant d'autres, mais nous estimons que l'echantillon que nous avons donné représente suffisamment l'objet proposé.

10. Exactement dans le sens contraire, Gomes de Sousa "Compendio de Legislação Tributaria", 1964, pags. 107-108.

11. Et de façon identique, E. Antonio "Studi di Diritto Tributario" Giuffrè, 1959, chap. relatif à l'évasion et évitation fiscales.

12. A l'intérieur de ce jeu de mots, la confusion terminologique à laquelle nous nous référons nous mènerait à des faits auxquels nous ne nous attendons pas si nous comparions l'opinion de Giorgetti sur l'intime relation qui existe entre le phénomène de l'évasion et celui de la translation (Ouv. cit. pag. 5) et les considérations de Cardyn et Delapierre sur l'évasion fiscale comme l'une des procédures acceptées afin d'échapper à la loi ("Frauder . . . ou payer ses impôts", Bruxelles, 1962, chapitre 3). De toute façon, et malgré l'absurdité de la thèse dans un ordre purement conceptuel, il est bon de rappeler les énormes difficultés auxquelles s'est heurté Antonini lorsqu'il a voulu faire la distinction entre évitement et évasion dans le cadre des impôts italiens sur l'Enregistrement et les Successions.

13. A l'encontre Palao Taboada "El fraude a la ley en el Derecho Tributario", Rev. Der. Fin. no. 63, pag. 678.

14. Sur ce point, les controverses les plus intéressants ont surgi à l'occasion du commentaire sur des préceptes comme le paragraphe 4 de l'article 396 A.O., ou du dernier paragraphe de l'article 46 de la loi argentine no. 11.863. En ce qui concerne le premier, nous pouvons voir les interprétations de Blumenstein, Hensel ou Giorgetti, que nous avons déjà citées; pour le second, les interprétations dispares de D. Jarach ("El hecho imponible", p. 146 et ss.), F. Martinez ("Estudios de Derecho Fiscal", pag. 169 et ss.) et C.M. Giuliani ("Derecho Financiero", II, pag. 648 et ss.)

15. Voir R. BARBOSA "Da interpretação e da aplicação das leis tributarias", 1956, pag. 66; D. JARACH "Curso Supérior de Derecho Tributario", 1959, I, page 278; DUARTE FAVEIRO "A forma juridica dos factos tributarios", Bol. Dir. Gen. Imp. 1960; MORELLO, "Frode alla legge", 1969, page. 182; F. MARTINEZ, ouv. cité.

que l'on puisse trouver dans le pays voisin sur le sujet. D'après cet auteur, une étude sur l'évasion fiscale est une étude dirigée vers l'examen des manifestations d'évitement des devoirs fiscaux et qui consistent, en particulier, dans l'évasion partielle ou totale de l'impôt, et par conséquent, le non-accomplissement des prestations exigées par l'obligation fiscale (pag. 3). Mais, et toujours d'après GIORGETTI, les violations des devoirs fiscaux ne sont pas à proprement parler des actes d'évasion (bien que grâce à eux, l'on obtienne les mêmes effets), parce qu'ils constituent des faits illicites. Mais cette idée ainsi que les termes qui servent à les exposer, perdent leur netteté dans les pages suivantes lorsque l'auteur fait le portrait de l'évasion, indiquant qu'il s'agit d'un "acte de violation d'un précepte fiscal" (pag. 81). Cette affirmation ne doit pas être considérée comme un lapsus de l'auteur, car quelques lignes plus bas, il conclut: "L'évasion , en tant que manifestation concrète, frauduleuse ou coupable d'opposition à la loi fiscale, ne peut exister juridiquement qu'en ce qui concerne l'accomplissement d'une obligation fiscale établie au préalable".[16]

La carte des confusions terminologiques n'en reste pas réduite aux doctrines allemande et italienne, bien qu'elles soient les plus représentatives dans ce secteur du Droit. Le panorama que nous offre la doctrine de langue française est à peu près identique. Nous voyons, par exemple, que M. LAURE[17] part d'un ample concept de fraude ("ensemble de comportements qui tendent à une réduction des prestations fiscales") totalement sans expression, qu'il divise ensuite en trois sous-produits: l'évasion, qui consiste à utiliser volontairement des situations non prévues (nous y voyons donc l'économie d'option, l'évitement et la fraude à la loi); le recel qui suppose la non déclaration de faits passibles de contribution; et la fraude dans un sens strict, qui consiste à donner une apparence de vérité afin de soustraction à l'imposition (nous pourrions y voir aussi la fraude à la loi fiscale).

Contre cette terminologie, CARDYN et DELPIERRE opposent les concepts suivants: l'ample concept de fraude est remplacé par celui de "moyens juridiques afin d'échapper à la loi". Parmi ces moyens juridiques, il y en a qui sont en eux-mêmes illégitimes (dissimulation et simulation), qui nous ramènent à la figure de la fraude; et d'autres "tolérés par l'usage". Il fait figurer entre ces derniers l'évasion fiscale (considérée au sens physique), le choix de la voie la moins coûteuse et la fraude à la loi fiscale.[18]

C'est SCAILTEUR qui dans la doctrine de langue française s'est le plus efforcé à introduire un certain ordre dans le chaos dont nous venons de parler. En 1950 ("Le devoir fiscal"), il niait au contribuable la possibilité de se soustraire à l'impôt en se servant de procédures qui ne se trouveraient pas indiquées et directement sanctionnées, parce qu'il n'y a aucun doute que "la loi fiscale doit interdire toute violation des préceptes". Ces violations peuvent nous conduire au concept de la fraude fiscale matérielle (violation directe de la loi) et intentionnelle (volonté de se soustraire à l'impôt par l'utilisation d'un moyen normal en lui-même, mais vicié en raison de sa fin). En 1955 ("La fraude légale"), l'auteur ajoute à la typologie indiquée le concept de "fraude légale" (forme d'évasion fiscale à cheval entre l'économie d'option et la fraude à la loi fiscale). Et enfin, en 1959, SCAILTEUR clôturait la liste des figures à considérer, définissant la fraude à la loi fiscale de façon assez classique: action au moyen de laquelle l'on viole l'esprit d'une loi tout en prétendant observer son texte.[19]

La situation de l'autre côté de l'Atlantique ne diffère pas tellement du panorama décrit. En 1943, dans cette splendide monographie intitulée "Le fait imposable", D. JARACH, soutenait que "l'évasion fiscale n'a besoin d'aucune réglementation spécifique de la part du législateur, parce qu'elle provient logiquement et directement des principes généraux et surtout du critère économique". Quelques années plus tard, en 1951, R. BIELSA ("Estudios de Derecho Público", vol. II) dans un désaccord sous-entendu par rapport au point de vue antérieur essaie de mettre sur pied une typologie complète des contraventions fiscales, qui vont de la violation ouverte à la loi, à une extrémité, jusqu'à l'évasion licite, à l'autre extrémité, et entre les deux, la fraude à la loi, la simulation frauduleuse et la fraude fiscale. C'est dans des termes identiques, mais beaucoup plus simplement que s'exprime GIULIANI FONROUGE ("Derecho Financiero", vol. II, 1962, id. 1977), qui centre son exposé sur deux figures: la fraude qui comprend l'évasion et l'évitement, punissable ou non en fonction de l'intention.[20] A.R. SAMPAIO DORIA ("Elisão e evasão fiscal", 1971) clôture cette liste et situe, dans une systématisation complète de la matière, aux extrémités de son schéma la fraude fiscale (illicite) et l'évitement (licite) et dans une position intermédiaire, nous trouvons l'évasion qui peut être soit omission ou commission, en fonction du rôle que joue, dans l'un ou l'autre cas, l'intention.

Et enfin, pour ne pas tomber dans un chauvinisme critiable, je dois confesser que la doctrine espagnole n'est pas restée à l'écart de cette confusion terminologique constatée sous d'autres latitudes. Ainsi, tandis que PALAO TABOADA identifie les concepts de fraude à la foi fiscale et l'évitement de l'impôt,[21] considérant illicites ces deux attitudes, CORTES DOMINGUEZ, sans établir de différence entre les deux figures, indique que la fraude à la loi est quelque chose d'absolument et de totalement différent de l'infraction légale, attendu que seulement en certaines occasions elle arrivera à se convertir en une activité illicite[22] et C. ALBIÑANA qui ne confond pas l'évitement et fraude à la loi fiscale, affirme que cette dernière constitue en général une conduite licite du contribuable.[23] MARTIN OVIEDO

16. Sous un même angle, plus avant, page 84.
17. Voir: "Traité de politique fiscale", Pres. Univ. Paris, 1956, chap. XIX.
18. Ouvrage cité, chapitre III.
19. "La fraude à la loi en Droit fiscal", Rec. Gén. Enr. Not. Id. "Principes de la répression des fraudes fiscales", St. on. A.D. Giannini, 1961.
20. C'est en des termes semblables que s'exprime J. TARANTINO, "La evasión fiscal del impuesto", Córdoba, 1959; et "El delito tributario", Buenos Aires, 1976.
21. De la même façon Blumenstein (suivant traduction de F. Forte), E. Antonini et G. Fonrouge "Derecho Financiero", II, pages 596 à 598.
22. Voir "Ordenamiento Tributario Español", Ed. Tecnos, 1958, page 145.
23. Voir "Notas sobre el ordenamiento español ante el fraude tributario" dans la IX Semaine Est. Dr. Fin. Et suivant la même opinion, Cardyn et Delapierre, ouvr. cité, chap. 3, S. de la Garza ("Derecho Financiero Mexicano", 1979, pag. 384) suit à peu près Albiñana, exception faite de quelques nuances introduites dans un ouvrage postérieur ("La evasión legal impositiva, REP. 1970).

ferme cette typologie d'attitude sans toutefois se prononcer expressément sur la distinction entre l'évitement et fraude à la loi fiscale ("fraude fiscale" dans la terminologie de l'auteur) et inclut cette dernière figure dans les actes contraires à la loi.[24]

Si nous considérons ces résultats, et avant de nous occuper du problème épineux de la clarification terminologique que nous avons décidé de faire, il faut souligner que ce qui importe ce ne sont pas les étiquettes, mais leur contenu. De toute façon, il est quand même intéressant de se mettre d'accord sur les noms qui vont désigner ces contenus.

Il semble nécessaire de partir d'un terme ample qui groupe tous les concepts auxquels nous avons fait allusion antérieurement. Ce terme pourrait être celui d'"économie d'impôt", élaboré par BLUMENSTEIN, ou simplement celui de "résistance devant l'impôt" dont nous parle G. SCHMOLDERS, attendu que tous deux expriment la même idée: la réaction du contribuable qui tend à réduire le plus possible le montant de ses versements fiscaux.

Mais cette réaction du contribuable devant l'impôt afin de rendre aussi faible que possible le volume de ses prestations fiscales peut suivre des voies licites ou illicites. Dans le premier cas, nous trouvons toute une série de figures, beaucoup d'entre elles d'empreinte panthaléonienne traitées de façon adéquate par la science des finances et que le droit fiscal s'est limité à reprendre puisqu'elles servaient à exprimer la liberté de choix dont doit jouir tout citoyen dans un Etat moderne à l'heure d'organiser ses relations économiques. Entre ces figures nous devons citer le déplacement, la suppression, l'évitement, l'émigration fiscale, l'économie d'option (LARRAZ), la recherche de la voie la moins imposée (CARDYN), etc.

Si le contribuable opte pour réduire le volume de ses prestations fiscales en se servant de moyens illicites, nous nous trouvons alors devant le concept d'infraction fiscale. L'infraction des règlements fiscaux peut présenter deux modalités: ouverte ou cachée. Entre les premières, nous devons citer la transgression, le recel et la fraude; les deux dernières sont des formes aggravées de la première, parce que nous y voyons un élément de vol, qui doit faire partie de la figure générique de la fraude. La forme typique d'infraction est la fraude de la loi.

Si nous comparons ces idées avec le titre du rapport, le lecteur peut opter pour rechercher une justification sociologique, psychologique et même légale pour le cadre terminologique confus décrit, en se fondant à cet effet sur l'une quelconque des opinions commentées antérieurement (ou d'autres qui ont été omises) ou essayer d'acheminer chacune d'elles vers leur propre cadre.

Si l'on suit la seconde voie, nous voyons que le terme "évasion" qui du point de vue grammatical ne peut être considéré que comme action de "sortir lorsque l'on est à l'intérieur (du fait imposable)" en raison de son amplitude extraordinaire et imprécision en limite l'utilité, dans le cadre juridique, à celle pouvant provenir de son utilisation pratique en tant que concept générique compréhensif de toutes les actions ou omissions illégales tendant à reduire le volume des prestations fiscales à verser.[25]

L'utilisation du terme évitement est encore plus problématique (L'Académie Royale le met sur un même pied que l'évasion) attendu que dans le langage ordinaire il est plus fréquemment comparé à des concepts moins chargés d'intention, comme le sont ceux qui tendent à éviter quelque chose. Sur ce point, je dois reconnaître que les difficultés ne sont pas minimes, car d'un côté, pour faire une différence technique entre les actions élusives (en principe, neutres) et les évasives (en principe, illicites) il faut faire passer les premières par la double épreuve du but poursuivi et des moyens utilisés ; d'un autre côté, l'expérience dans l'application de préceptes comme l'art. 10 A.O. 1931, l'art. 12 de la loi argentine 11.683 ou l'art. 24 de la LGF, expriment suffisamment le danger (et inutilité) de mettre en rapport l'évitement, pour une meilleure délimitation des autres figures semblables, et l'intentionnalité.[26] Et enfin, pour que du point de vue juridique il soit logique de poser le thème de l'évaluation et catalogation de conduites non situées dans le rayon d'action du fait imposable , il faut donc supposer que ces actions prétendent obtenir des effets très proches ou semblables de ceux examinés par le fait imposable, qu'il s'agit d'éviter ou d'escamoter. Ainsi donc, bien que le citoyen ait toute liberté de choisir les formes juridiques les plus adaptées à ses intérêts, que la réglementation fiscale ne permet pas d'infraction frauduleuse de ses règlements, l'évitement ou bien est une conduite licite protégée par le règlement, auquel cas nous ne voyons pas la nécissité de lui donner de nom specifique, ou il s'agit d'une conduite qui, sauvegardant le texte d'un précepte , prétend bafouer l'esprit (la ratio legis) de ce dernier ou de tout autre précepte du règlement. Cette façon de procéder reçoit depuis plusieurs siècles un nom spécifique dans le monde du Droit, et il n'y a aucune raison pour en changer la dénomination dans le Droit fiscal. Nous nous référons naturellement au concept de la fraude à la loi[27] sur lequel va se développer le restant de cet exposé, insistant tout particulièrement sur les instruments de caractère général dont se sert le règlement fiscal espagnol pour la combattre.

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24. Voir "El acto en fraude de la ley como especie del acto contrario a la ley" dans Mem. As. Esp. Dr. Fin. 1966. Amorós et Pérez de Ayala se prononcent aussi dans ces termes. Le premier de ces auteurs bien qu'acceptant sous réserve qu'entre les concepts de fraude fiscale et de fraude à la loi fiscale, il existe cette relation de genre à espèce dont parle Martín Oviedo, fait une distinction expresse entre la fraude à la loi fiscale et l'évitement, identifiant cette dernière avec l'économie d'option ("La elusión y la evasión tributaria", Rev. Der. Fin. Hda. Pub. 1965 et "La infracción fiscal: concepto y naturaleza", Me. Asoc. Esp. Der. Fin. 1966). Sans toutefois l'affirmer de façon catégorique, nous pourrions dire qu'il s'agit là aussi de la pensée de Pérez de Ayala qui nomme "évitement" ce qui nous semble une "économie d'option" (voir son "Derecho Tributario", 1968, page 133); tandis qu'il réserve le terme "économie d'option" pour les possibilités que le propre législateur offre aux contribuables, sans infraction ou camouflage quelconque, ni intention frauduleuse entre les deux formes juridiques et leur traitement fiscal correspondant différent (voir: "Las ficciones en el Derecho Tributario", 1970, page 146).

25. Le titre de l'ouvrage de J. García "El delito de evasión fiscal", Buenos Aires, 1961 est très intéressant.

26. Sur ce point, en plus des ouvrages classiques de D. Jarach et F. Martinez, dont nous avons déjà parlé, nous pouvons voir, de façon résumée, notre ouvrage "La cosidetta evasione fiscale legittima", Riv. Dir. Fin. Sc. Fin, 1974.

27. Cfr. La nouvelle rédaction donnée à l'article 24 LGF par l'art. 34 du projet de loi sur les Infractions et Sanctions Fiscales.

III. LA VERITABLE NATURE DU FAIT IMPOSABLE EN TANT QUE MECANISME DE REACTION FACE A LA FRAUDE A LA LOI FISCALE ANALYSE DE L'ART. 25(1) LGF

L'art. 25(1) de la Loi Générale Fiscale qui non sans raison a été considérée comme le meilleur instrument et le plus généralisé pour combattre la fraude à la loi fiscale, dispose: "L'impôt sera exigé conformément à la véritable nature juridique ou économique du fait imposable".[28]

Naturellement, trouver la véritable nature du fait imposable plus qu'un instrument de lutte contre la fraude à la loi fiscale constitue le but final, attendu que précisément, l'on tente, en qualifiant un fait imposable présumé frauduleux, de trouver la véritable nature juridique ou économique du soi-disant fait réalisé par les parties, afin de le diriger vers le fait imposable qui lui est propre. Naturellement, le problème consiste à mettre à jour, entre les deux natures, celle évoquée par les intéressés ou celle révélée par l'Administration, la véritable.

Nous savons que l'essence de la fraude à la loi fiscale consiste à obtenir les mêmes résultats économiques que le règlement en question voulait imposer en s'appuyant sur les termes d'un autre précepte dicté dans une fin différente.[29] C'est-à-dire, le mécanisme de la fraude à la loi fiscale se fonde sur deux principes fondamentaux: 1°. que l'obligation légale de payer un impôt dépende de la réalisation du fait imposable et non de la réalisation de certains buts économiques; 2°. que, dans le choix du moyen juridique le plus apte pour l'obtention de certains buts économiques, les contribuables jouissent d'une pleine liberté.[30]

Si l'on part de cet indice et l'on n'y introduit aucune nuance, il semble évident que nous pourrions en réalité y trouver deux genres de conduites antithétiques: a) des cas dans lesquels le contribuable obtient le fait imposable établi par un règlement vide du contenu économique que le règlement fiscal prétend recueillir; b) les cas où le contribuable obtient des revenus économiques qu'un fait imposable désire grever et ce en se servant de voies différentes de celles établies par le règlement fiscal en question. A cet effet, le contribuable dispose de deux collaborateurs très efficaces: le négoce indirect et le négoce simulé.[31]

Ce qui caractérise les comportements comme ceux indiqués et en ce moment, je ne pense pas tellement au négoce indirect, sinon plutôt à la dissimulation, c'est qu'il y a une différence entre eux, recherchée délibérément, entre l'intention économique concrète poursuivie par les parties qui réalisent le négoce juridique et la cause typique de ce dernier.[32] Deux conséquences fondamentales pour le sujet qui fait l'objet de cette étude proviennent de cette appréciation.

La première consiste à évaluer les facilités qu'offre le négoce indirect et la dissimulation pour obtenir des fins non protégées par le Droit. C'est-à-dire l'une des caractéristiques communes au genre d'affaires considérées émane des moyens ou procédures habituelles qui servent à obtenir des buts que le règlement juridique n'estime pas dignes de protection.

La seconde dépend du résultat obtenu dans la polémique sur le rôle de la cause dans les affaires juridiques. Si, comme dans le cas espagnol, le règlement est franchement motivé, l'existence, tant dans le négoce indirect que dans la simulation, d'une cause illicite, nous amène à considérer que ces négoces ne sont pas susceptibles de confirmation.

Après avoir précisé les points communs et ceux qui différencient le négoce indirect et la dissimulation sous la forme indiquée, nous devons maintenant comparer ces figures avec la fraude à la loi fiscale. Ainsi, l'intention précise des lignes qui suivent doit être: 1°. souligner ce qu'il y a de commun entre négoce indirect, simulation et fraude à la loi fiscale; 2°. préciser les points qui les différencient; 3°. insister sur les obstacles qui s'opposent à une nette différence dans la réalité du trafic ordinaire.

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28. La claire inspiration de ce précepte dans les règles de qualification du fait imposable propre aux impôts qui grèvent le trafic juridique nous évite d'entrer en ce moment sur un terrain aussi polémique que connu. Nous nous référons au principe de l'impôt conformément à la véritable nature juridique de l'acte ou négoce grevé et au principe d'abstraction des défauts de fond et de forme qui en affecte la validité. Voir pour tous, M. Conde "El principio de calificación", dans "Impuestos sobre sucesiones, transmisiones patrimoniales y actos jurídicos documentados". Madrid 1977, vol. II; et Pérez de Ayala et E. González "Curso de Derecho Tributario", Madrid 1978, vol. I, pages 98 et ss. Et en Droit Comparé, nous pouvons voir une ample bibliographie en ce qui concerne l'article 8 de la loi italienne sur l'Enregistrement.

29. Cfr. arts. 24(2) et 6(4) C.C.

30. Voir Jugement du T.S. du 27 juin 1974 (Aranzadi no. 3116) et Arrêté du TEAC du 4 décembre 1979.

31. D'après Kohler, dans le négoce indirect qui se veut un négoce avec toutes ses conséquences, mais pour des fins économiques non homogènes avec le propre négoce ou avec ses effets juridiques. Ce qui caractérise le négoce indirect – dit Betti, paraphrasant Kohler – c'est que les parties veulent effectivement le négoce, parce que sa cause typique n'est pas incompatible avec le but qu'eux-mêmes poursuivent, mais simplement incongruent. Ainsi donc, dans le négoce juridique indirect on ne cache pas une réalité juridique, ce que l'on essaie de cacher, c'est une réalité économique. Il s'en suit que ce que l'on essaie de cacher, c'est une réalité économique. Il s'en suit que ce que l'on veut c'est réellement le négoce mais non sa cause typique, attendu qu'il est utilisé au service et comme moyen d'atteindre des résultats économiques différents (*Teoría General del Negocio Jurídico*, p. 300 et ss.)
Pour Kohler, le négoce simulé n'est qu'une apparence, un négoce qui en réalité n'est nullement désiré par les parties. En précisant davantage cette idée fondamentale, FERRARA affirme que dans le négoce simulé, il y a une apparence contraire à la réalité, soit parce que celui-ci n'existe pas (simulation absolue), soit parce qu'il est différent de l'aspect sous lequel il apparaît (simulation relative). De cette façon, la simulation apparaît sous deux aspects: a) dans la simulation absolue proprement dite, il n'existe qu'un seul négoce (celui désiré par les parties), car dans celui que nous pourrions appeler négoce simulé, l'on feint une réalité juridique inexistante. b) Dans la simulation relative, il y a deux négoces: celui qui apparaît en superficie, c'est-à-dire, le négoce simulé, (non désiré par les parties) et celui qui leur appartient. Ainsi, dans le négoce relativement simulé, celui qui présente le plus grand intérêt pour le thème de notre étude, l'importance de l'affaire réside dans les termes de l'accord passé par les parties; le négoce apparent (simulé) n'est pas désiré, mais il sert à proportionner une façade juridique différente du négoce caché (dissimulé), qui est celui que l'on désire effectivement (*La simulación de los negocios jurídicos*, p. 77 et ss.)
Si nous comparons ces idées avec ce que nous avons indiqué en ce qui concerne le négoce indirect, il n'est pas difficile d'en arriver à la conclusion que, dans la simulation, la différence entre la cause typique de l'affaire choisie et l'intention poursuivie concrètement par les parties ne peut en être réduite aux termes d'une simple incongruité, sinon qu'elle donne lieu à une véritable incompatibilité. Incompatibilité qui exclut toute possibilité de correspondance entre la cause typique du négoce choisi et l'intention des parties, attendu que le négoce n'a pas été en réalité désiré, si ce n'est qu'en apparence. Les parties étant d'accord, elles établissent un règlement d'intérêts différents de celui auquel elles pensent soumettre leurs relations, essayant d'obtenir du négoce simulé un but incompatible avec la cause typique.

32. Betti, ouv. cité, pages 143-144.

En ce qui concerne le premier, et après tout ce qui a été indiqué, il n'est pas difficile d'apprécier que les comportements dans la fraude à la loi fiscale réalisée au moyen de simulation et négoces indirects sont caractérisés par le fait que le but économique poursuivi par les parties diffère de la cause typique du négoce réalisé au service de ce but. C'est-à-dire, qu'il existe un manque de coïncidence entre la fin poursuivi par les parties et la forme juridique adoptée. Ce qui équivaut à affirmer que la relation entre les négoces anormaux (simulation et négoces indirects) et la fraude à la loi fiscale proviennent du fait que l'on recherche grâce à eux des effets ou des fins qui ne peuvent être obtenus au moyen de voies normales protégées par le Droit. De sorte que, dans le fond, l'affinité entre ces figures se doit à ce que la cause est illicite, puis qu'elle veut obtenir un résultat que le Droit n'estime pas digne de protection. Circonstance qui a entraîné certains auteurs à affirmer qu'il ne peut pas y avoir de fraude à la loi fiscale sans simulation.[33]

En réalité, tant dans les négoces anormaux que dans la fraude à la loi fiscale, les figures juridiques correspondantes se contorsionnent afin d'éluder l'application d'une loi sur certains résultats. De cette façon, la différence entre la fraude à la foi fiscale et les négoces anormaux se complique énormément attendu que dans ces derniers, le négoce apparent est une réalité objective, réalité qui, comme dans la fraude à la loi fiscale, est couverte par l'apparence de formes différentes. Et le problème se complique encore plus si nous observons que ces négoces apparents peuvent être parfaitement légaux.[34] Mais tant qu'ils seront menés dans l'intention de frauder, il semble évident qu'ils comporteront un vice dans la cause parce que celle-ci n'existe pas ou est fausse. En ce qui concerne la seconde question que je voulais examiner, c'est-à-dire, l'existence ou non de notes de différences fondamentales entre la fraude à la loi fiscale et les figures objet d'étude, il semble bon de commencer cet exposé à partir de deux affirmations précises et indubitables: la première, nous ne pouvons affirmer que toutes les fois que nous nous trouvons devant une simulation ou un négoce indirect qu'il existe une figure de fraude à la loi; la deuxième, le negoce indirect et la simulation sont des instruments habituels de fraude à la loi fiscale, mais ne sont pas frauduleux en eux-mêmes.[35]

Les négoces simulés ou indirects ne sont pas en eux-mêmes des actes de fraude ou contre la loi; en effet, ainsi que l'indique FERRARA, la simulation n'est pas en soi un acte de fraude, sinon qu'elle peut servir à en cacher la réalisation. Le fait que l'on emploie normalement la simulation au service de la fraude, n'empêche pas que l'on puisse, d'un point de vue conceptuel, établir leur différence. Et en ce sens, c'est FERRARA lui-même, l'un des auteurs qui avec le plus de précision a tracé les contours de l'une et l'autre figure. Pour l'illustre auteur, le négoce simulé veut donner une apparence, alors que le frauduleux est une réalité; le premier possède un caractère "fictif et non voulu", tandis que le second est réellement désiré, et par son utilisation, les parties essaient d'obtenir un résultat défendu. Rien de tout cela ne se produit dans la simulation, qui n'est jamais un instrument tentant d'éviter la loi, sinon une arme très efficace pour en cacher la violation, attendu que la transgression du règlement se trouve enfouie sous l'apparence d'un négoce illicite.[36]

Ainsi, du point de vue de la fraude à la loi fiscale, ce caractère d'instrument de la simulation et le négoce indirect ne doit pas nous faire oublier, tout au moins du point de vue conceptuel, qu'entre cette simulation et la fraude à la loi il existe une différence substantielle: dans la simulation, il y a deux actes ou négoces juridiques, chacun d'eux s'adaptant à la finalité qui, l'un réellement et l'autre apparemment sont poursuivies; dans la fraude à la loi fiscale, il n'y a qu'un seul négoce juridique dans lequel, malgré tout, il existe une différence entre la cause objective et la finalité poursuivie par les parties.[37] Il s'ensuit que cette différence plus que suffisamment cachée dans l'intention des parties ne précise pas ex necese de l'ultérieure couverture qui pourrait lui proportionner une forme juridique apparente, ce qui ne veut en aucun cas dire que la forme juridique apparente soit de trop. De toute façon, la base du fait illicite de la fraude de la loi fiscale apparaît clairement dans cette doctrine, puisque grâce à elle, l'on recherche à ne pas payer un impôt qui en réalité est dû.

Après avoir établi ce qu'il y a de commun entre les négoces anormaux et la fraude à la loi fiscale, et avoir précisé leurs points de différence, nous devons examiner les obstacles qui s'opposent à l'établissement de la différence entre les figures du trafic ordinaire.

De ce point de vue, c'est RUBINO qui a le plus mis en doute la possibilité d'apporter sur le terrain des faits une distinction qui théoriquement est inattaquable. Pour l'illustre auteur, il est impossible, en matière fiscale, d'établir une séparation totale entre le fait frauduleux et d'autres activités ou institutions qui l'accompagnent, attendu que celles-ci sont normalement utilisées comme instruments pour obtenir le premier. Il s'ensuit que s'il existe des actes de simulation sans fraude, il y en a d'autres qui naissent de la fraude.[38]

C'est-à-dire que le noyau de l'argumentation consiste à admettre la différence théorique entre négoce indirect et simulation d'un côté et fraude à la loi fiscale de l'autre, pour ensuite, dans la pratique, nier la valeur d'une semblable distinction, attendu qu'il n'y a pas d'exemple concret où la fraude à la loi fiscale ait lieu sans qu'en un moment déterminé entre en jeu l'instrument de la simulation. Ainsi que nous l'avons dit de façon claire et précise: "dans la technique du droit fiscal, il est impossible d'établir la séparation aseptique que réalise la doctrine entre la fraude à la loi et la simulation".[39]

Et enfin, pour en terminer avec tout ce que nous avons indiqué , nous devons nous poser cette question: En ce

33. Voir Amorós, *La infracción fiscal* . . . ,cit. pages 391-92; Palao Taboada, *El Fraude* . . . , cit. pages 684-85 et Pérez de Ayala, *Las ficciones en el Derecho Tributario,* Madrid 1970, pages 161 à 163.
34. Eluder un négoce n'est pas forcément immoral. Voir Ferrara, *La simulación* . . . cit., pages 77 et ss. et Betti, *Teoría General* . . . , cit. pages 300 et ss.
35. Nous observons que cette deuxième affirmation comprend et nuance la première.
36. Dans ce même sens, F. de Castro, *Derecho Civil de España,* Madrid, 1955, pages 604-605.
37. Voir Palao Taboada, ouv. cit. page 685.
38. Voir *El negocio jurídico indirecto,* Madrid, 1953, page 123.
39. Voir Amorós, *La infracción* . . . cit. pag. 391 et 408-409. Et aussi Jugement du T.S. du 9 décembre 1957 (Aranzadi no. 3380).

qui concerne la fraude à la loi, est-ce que la thérorie qui situe la naissance de l'obligation fiscale de la réalisation du fait imposable jouit d'une exception?

Pour répondre à cette question, il faut se rappeler que le législateur fiscal, lorsqu'il a établi les faits imposables correspondants a examiné certains faits de la vie réelle qui, révélateurs de certaines capacités de contribution doivent être soumis à un traitement fiscal déterminé consistant, en général, dans le paiement d'un impôt. Une fois ce labeur réalisé, après l'approbation et promulgation de la loi fiscale, l'interprète ne peut, au cours de l'application du règlement, modifier l'esprit du législateur en s'y substituant, considérant que la réalité économique, objet de l'impôt, a été très peu analysée. Mais ce que peut et doit faire l'interprète – et sur ce point nous sommes tout à fait d'accord avec PEREZ DE AYALA – c'est essayer de définir quelle est la relation qui existe entre le fait imposable typique et l'objet économique de l'impôt que veut saisir le législateur. "Non pour appliquer le second au lieu du premier, mais pour éviter que, jouant sur les pures formes juridiques et la littéralité des préceptes légaux, les faits imposables et les lois fiscales soient, respectivement, activés et appliqués à des réalités économiques qui n'ont rien à voir avec celles que le législateur a élaborées. Pour éviter en somme, la fraude à la loi, et pour qu'à tout moment le fait imposable et la règle désirée par le législateur soient appliqués et non ceux recherchés par le contribuable frauduleux"[40]

IV. L'ANALOGIE EN TANT QU'INSTRUMENT DE LUTTE CONTRE LA FRAUDE A LA LOI FISCALE

Mais nous voyons dans notre cas s'ajouter aux déficiences provenant de l'utilisation de l'analogie en tant qu'instrument de lutte contre la fraude à la loi, la malheureuse rédaction de l'article 24(2) qui, en premier lieu, établit le centre de gravité de la fraude à la loi dans l'"intention d'éluder l'impôt", et tout de suite après, exige de l'Administration l'établissement d'un dossier où figurent les preuves de cette intention.[41] Dans ces conditions, il est tout à fait normal que l'article 24(2) soit devenu un instrument totalement inefficace de lutte contre la fraude à la loi fiscale et que ce rôle ait été en grande partie assumé par l'article 25 LGF.

La relation entre les art. 24 en 25 de la Loi Générale Fiscale, quatre exposants d'une intention unique et décidée (quoique mal configurée) de lutte contre la fraude à la loi fiscale a été soulignée par PALAO TABOADA, lorsqu'il a observé que non seulement l'on devrait tenir compte à cet effet, comme il en est pour ainsi dire toujours, de l'article 24, mais qu'avec lui et de façon spéciale, il faudrait considérer l'article 25, attendu que "tous les cas possibles de fraude à la loi fiscale sont compris dans ce concept".[42] L'on a pris, pour cette raison, l'habitude, dans la doctrine espagnole, de diviser l'étude de cet article 24 en suivant sa configuration positive. De cette façon, l'on considère en premier lieu le problème de l'analogie dans le droit fiscal, et en deuxième lieu, le rôle qui correspond à l'analogie en tant qu'instrument technique de lutte contre la fraude à la loi fiscale.

L'analyse que l'on fait dans notre règlement de l'analogie en tant que dossier technique à utiliser par l'Administration fiscale dans sa lutte contre la fraude à la loi est expressément acceptée par PEREZ DE AYALA (tout en y faisant quelques réserves) et par MESONERO-ROMANOS, et de façon plus tacite par AMOROS, attendu que bien que cet auteur se prononce pour la nécessité d'un exposé général sur la fraude à la loi, menant à la nullité de ces actes, il reconnaît de toute façon l'efficacité pratique du mécanisme de réaction recueilli dans le paragraphe 2 de l'article 24.[43]

Par contre PALAO TABOADA et CORTES DOMINGUEZ sont totalement contraires à la position antérieure. D'après ce dernier auteur, et sa systématisation nous semble correcte, lorsque la formule établie par le législateur ne comprend pas tous les faits par lesquels l'on peut arriver à des résultats économiques identiques à ceux examinés par le fait imposable, "l'utilisation d'une des formules non soumises ne peut donner lieu à la naissance d'une obligation fiscale qu'en suivant l'une de ces deux voies: Ou l'on estime qu'il y a fraude à la loi, ou l'on applique la procédure analogique établie dans le paragraphe 2 de l'article 24".[44] C'est-à-dire, la procédure établie par le paragraphe 2 de l'article 24 et la correcte réception dans les ordonnances fiscales de la théorie de la fraude à la loi utilisent deux voies différentes, bien que toutes deux prennent source d'une même point: le désir d'imposer des situations qui bien que cela puisse paraître contraire, sont en réalité recueillies par un certain imposable. Mais, la différence entre l'une et l'autre voie est claire. Sans nier lettre de nature à l'analogie dans le Droit fiscal en raison de sa propre entité juridique, cette forme d'interprétation ne peut être admise que lorsque le fait établi par le règlement le permet, chose qui n'est guère facile à l'intérieur des ordonnances fiscales actuelles, de plus en plus casuistiques et dont la ratio legis s'épuise dans la disposition en question.

Nous voyons de tout ce qui vient d'être indiqué qu'une fois la fraude à la loi admise dans une ordonnance, il n'y a aucune raison pour faire allusion à l'application analogique en tant que mécanisme de réaction, parce qu'il s'agit de l'essence de la figure qui nous occupe et que l'Administration fiscale doit affaiblir l'effet juridique du fait imposable adopté par le contribuable et procéder à reconstruire au moyen de l'interprétation de la réalité économique cachée sous une forme juridique apparente, le fait imposable qui convient à cette situation juridique. C'est-à-dire qu'il s'agit, en dernier ressort, de faire coïncider la volonté des particuliers avec la cause typique

40. Voir, *La Naturaleza . . .* , cit. pag. 563.

41. Voir Jugement du T.S. du 7 novembre 1978 (Aranzadi no. 3463); et Arrêtés du TEAC du 20 décembre 1966 (Pub. Min. Fin. no. 260) et 11 février 1969 (Pub. Min. Fin. no. 33). M. Arias *"Fraude de Ley y economía de opción"*, Est. Der. Trib. Madrid, 1979, vol. I, pages 519 et ss.

42. *"El fraude a la ley en Derecho Tributario"*, cit.

43. Voir, *"La elusión . . .* , cit. pages 605-66 et *La infracción fiscal: concepto y naturaleza"*, Mem. Asoc. Esp. Der. Fin. 1966, pages 496 et ss. Sur ce point, voir aussi Martín Oviedo: *"El acto en fraude de ley como especie DEL acto contrario a la ley"*, 1967, page 311.

44. *"Ordenamiento tributario Español"*, 1977, pages 130 et ss. Cette idée que nous avons vue formulée pour la première fois chez Palao Taboada (Ouv. cit. pages 691-92) fut à l'origine partagée par Pérez de Ayala ("La naturaleza de las leyes fiscales y el problema del fraude a la ley tributaria". Mem. Asoc. Esp. Der. Fin. 1966, pages 558 et ss.)

d'un négoce juridique choisi par eux-mêmes.

Comment peut-on expliquer alors que la Loi Générale Fiscale recourt à l'analogie pour combattre la fraude à la loi? En réalité, la solution de ce paradoxe n'est guère facile, mais nous croyons que cela peut se faire, ou tout au moins plus facile que de couper net l'essai.

Pour comprendre le paragraphe 2 de l'article 24 de la Loi Générale Fiscale, il faut tenir compte que le précepte de fraude à la loi a été élaboré par un secteur juridique différent du secteur fiscal, faisant sont entrée dans le Droit fiscal, surtout par la voie jurisprudentielle.[45]

Heureusement pour notre thèse, l'une des critiques les plus ardues qui ait été faite sur ce point à notre jurisprudence date de 1952. Et rien de plus agréable en cette occasion de voir que LARRAZ est arrivé à une conclusion à peu près semblable à celle qui onze ans plus tard donnerait lieu au texte légal que nous commentons. En effet, d'après LARRAZ: "Dans la technique du Droit Civil, la correction du fraux legis est obtenu au moyen de la nullité de iure. Dans la technique du Droit fiscal, cette nullité n'existe pas; la correction se fait au moyen de la méthode critique qui donne une interprétation extensive du texte d'imposition, l'affaire restant in fraudem prouvée, la voie choisie pour échapper n'en étant pas moins une fraude et bien pris est celui qui a cru pouvoir duper le pouvoir public.[46]

Les considérations précédentes ont essayé de donner une explication généralement absente dans la valoration critique du précepte qui nous occupe. Mais expliquer ne veut pas dire justifier et encore moins admettre. Le paragraphe 2 de l'art. 24 de la Loi Générale Fiscale, en tant qu'instrument de lutte contre la fraude à la loi tombe dans ces contradictions et défauts de technique juridique et, en marge de sa moindre ou plus grande valeur pratique, doit être abandonnée en tant que procédure idéale pour combattre la fraude à la loi fiscale dans la phase d'application des règlements.[47]

V. CONSIDERATIONS DE CONCLUSION

Nous avons surtout voulu développer deux lignes d'arguments au long de l'exposé précédent. La première, de caractère méthodique, prétendait offrir une unité désirable de terminologie, indispensable au développement de toute science et en particulier nécessaire dans le monde du Droit. La seconde, de caractère interdisciplinaire, a essayé, sur la base présentée par les art. 24 et 25 LGF d'apporter une constitution complémentaire aux termes des relations entre l'intentio facti et l'intentio iuris à l'occasion de la réalisation d'actes et négoces juridiques pris en considération par le Droit fiscal.

La thèse de l'assimilation pure et simple par le Droit fiscal des institutions de droit privé sous la forme indiquée par leur secteur d'origine respectif, pose de délicats problèmes en matière de fraude à la loi fiscale et difficilement acceptés.[48]

Au cours des temps, des solutions à ce difficile problème dont on a dit bien souvent "mettre des portes à la campagne", ont suivi divers chemins: a) ce problème n'existe pas, dira-t-on, à partir d'une position exaltée de l'autonomie de la volonté, nuancée, parfois de formalisme juridique,[49] car celui qui fraude la loi agit légalement et l'on doit respecter, en tout cas, la volonté des parties en raison de la coïncidence normale et naturelle du négoce choisi pour sa cause typique; b) au contraire, l'on a dit aussi avec toute autorité que "la liberté des parties pour conclure des affaires utilisant les formes juridiques les plus intéressantes, malgré tout, est absolument insignificante pour le régime d'imposition de leurs relations économiques", ce qui importe réellement, c'est la relation économique qui constitue l'apparition d'un fait imposable et ceci peut être déterminé au moyen de l'interprétation et la réglementation contre la fraude à la loi fiscale[50] n'est donc nullement nécessaire; c) des positions lointaines, antérieures à celle dernièrement nommée, l'on a affirmé que pour définir la fraude à la loi, la divergence entre les formes juridiques adoptées par les parties et le but économique poursuivi n'étaient pas suffisants, il faut de plus l'existence d'une volonté d'éluder l'impôt;[51] d) un autre secteur de la doctrine considère que l'essence de la fraude à la loi fiscale prend naissance dans la discorde

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45. L'influence de notre jurisprudence dans la rédaction du paragraphe 2 de l'art. 24 est telle que jusqu'à cette confusion entre analogie et interprétation extensive qui y est si fréquente (voir Amorós: "Ley General Tributaria", cit. art. 24), se retrouve dans le texte légal.

46. Ouvrage cité, page 61.

47. La doctrine s'est bien souvent prononcée sur les difficultés théoriques et pratiques de la procédure spéciale dont il est question dans la dernière phase dudit paragraphe. Voir avant l'apparition du Décret du 29 juin 1979 (régulateur de la procédure de référence) M. Arias, o. cit. p. 519 et ss.; et plus tard, C. Albiñana "Derecho Financiero y Tributario", Madrid 1979, p. 395 et ss.
Ces difficultés augmentent lorsqu'il s'agit d'interpréter avec harmonie le texte de la procédure de référence, tendant à prouver "le désir d'éluder l'impôt" avec le deuxième paragraphe de l'article 35 de la Loi 50/77 du 14 novembre, qui limite, d'après moi, sans aucune justification, l'existence du désir de fraude aux cas de "falsifications ou anomalies substantielles en comptabilité" et au "refus ou obstruction au contrôle de l'Administration fiscale". Il est un fait que l'on peut considérer que la procédure de l'article 24(2) de la LGF tend à prouver l'intention d'éluder "le fait imposable" (et non "l'impôt") alors que l'intention de fraude de l'article 35 de la Loi 50/77 considérait la quote ("fuite du paiement d'impôts"), mais de toute façon nous ne voyons pas la raison d'exalter les falsifications ou anomalies comptables et méconnaître les falsifications ou anomalies juridiques. Voir la Circulaire 2/78 du Fiscal de la Cour Suprême sur la Persécution du Délit Fiscal.

48. Voir E. Becker: *"Accentramento e sviluppo del Diritto tributario tedesco"* dans Riv. Dir. Fin. Sc. Fin. 1937, p. 162 et ss.; du même auteur et dans la même revue *"Applicazione della legge d'imposta secondo criteri economici obbiettivi nella giudisprudenza della Corte Finanziaria del Reich"* et sous forme résumée, A. Hensel: *Diritto Tributario,* Giuffrè 1956, p. 144 et ss; en espagnol, l'on peut voir l'excellent exposé de D. Jarach: *El hecho imponible,* Buenos Aires, 1971, pag. 131 et ss. Il faudrait sur ce point trouver un accord pour une unification de la terminologie et rejeter le terme "évasion". Contre cette idée, entre autres, Amorós, Giorgetti, Sampaio et Tarantino. Voir notre ouvrage: *La cosidetta evasione fiscale legittima,* cit.

49. Voir, par exemple, C. Albiñana: *Derecho Financiero y Derecho Tributario,* Madrid 1979, p. 392; A. Berliri: Le leggi di registro, Giuffrè 1960, pag. 141 et ss.; E. Antonini: Evasione ed elusione di imposta", en Studi di Diritto Tributario,, Giuffrè, 1959, pag. 9 et 16 et ss. et *"Equivalenza di fattispecie tributarie ed elusione di imposta",* dans Riv. Dir. Fin. Sc. Fin. 1966, p. 169 et ss. Bien qu'extériorisée de façon plus nuancée, l'opinion de F. Martinez conserve avec l'idée antérieure une certaine parentée: *"El criterio económico. La importancia que para el Derecho Fiscal tiene la divergencia en el negocio jurídico entre la intención empírica (intentio facti) y la intención jurídica (intentio iuris)"* dans Estudios de Derecho Fiscal, Buenos Aires, 1973, Jarach lui-même dans ses "Prologues" à la 2è edic. de *El hecho imponible* et à l'ouvrage cité de F. Martínez, a souligné les liens et différences qui existent entre les deux positions.

50. Voir Jarach: *El hecho imponible,* cit. pages 131. et ss. et 146 et ss. et H.W. Kruse: Steuerrecht, Munich, 1973, pages 98 et ss. Sous une forme résumée, Jarach: Curso Superior de Derecho Tributario, Buenos Aires, 1969, pages 294 et ss., et H. Villegas: *Curso de Finanzas, Derecho Financiero y Derecho Tributario,* Buenos Aires, 1972, page 135.

51. Voir E. Bluemstein: *Sistema di Diritto delle Imposte,* cit. pag. 27; A.R.

entre le but objectif du négoce, c'est-à-dire, sa cause typique et la volonté manifeste des parties à l'heure de choisir pour leur but une formule juridique inadéquate ou impropre et qu'il est donc suffisant de ramener dans le bon chemin, celui de la cause typique, au moyen de l'interprétation opportune, le négoce réalisé par les parties;[52] e) finalement, comme complément, ou nuance de la dernière thèse mentionnée et toujours à l'intérieur de la fraude illicite à la loi fiscale, l'opinion de A.D. GIANNINI nous semble très intéressante: "des difficultés surgissent dont la solution est ardue lorsque la situation juridique qui naît de la relation privée ne coïncide pas avec celle des faits. La question est de savoir si l'on doit réserver à de tels cas une influence décisive au moment de l'application de l'impôt à l'un ou l'autre élément (il se réfère à la forme juridique privée ou à la réalité économique) il n'est pas possible de donner une solution unique ni du point de vue rationnel ni conformément à la loi positive; la seule chose que l'on puisse faire est d'établir des critères d'orientation".[53]

Ainsi donc, pendant qu'un secteur doctrinal (BLUMENSTEIN, PALAO, PÉREZ de AYALA, XAVIER et l'auteur de cet exposé, entre autres) considèrent comme motif suffisant à notre avis une accumulation de moyens dans la lutte contre la fraude à la loi, un autre secteur doctrinal (AMATUCCI, CRISAFULLI et MICHELI, entre autres) nous mettent en garde avec des motifs suffisants contre les dangers auxquels pourrait se heurter le principe de capacité de contribution à l'occasion d'une utilisation peu rigoreuse des présomptions et fictions légales.[54]

Nous nous heurtons ici à un thème d'actualité permanente dans le secteur du Droit Fiscal: la tension entre les principes de sécurité juridique et la capacité de contribution.[55] Et ceci parce que dans le monde du Droit, comme dans beaucoup d'autres, tout est uni.

Sampaio Doria: *A. evação fiscal legitima: conceito e problemas, Ciencia e Tecnica Fiscal,* 1970, pages 41 et ss.; H.W. Kruse; *Steuerrecht,* cit. pages 113 et ss. et A. Xavier: *Manual de Direito Fiscal,* Lisboa, 1974, pages 254 et ss. L'art. 24 de la Loi Générale Fiscale suit le même courant et il nous a été impossible de nous en éloigner lorsque nous avons rédigé notre ouvrage sur la *cosidetta evasione fiscale legittima,* cit. Mais de notre côté, et ce critère est actuellement soumis à révision, en partie parce qu'il n'existe peut-être pas d'élément intentionnel, mais surtout en raison des difficultés pratiques dues aux mécanismes probatoires correspondants. Naturellement, cette position face à l'élément intentionnel n'affecte pas la volonté présente dans tout acte juridique. Dans cette même ligne, voir pour tous, F. Pérez Rojo *"Infracciones y sanciones tributarias",* Madrid 1972, pages 80 et ss. La considération française est moins claire à cet effet, voir, par exemple, B. Taddei: *"La fraude fiscale",* Paris 1974, pages 75 et ss. et 86 et ss.

52. Voir C. Palao: *El fraude a la ley en Derecho Tributario"* en Rev. Der. Fin. Fin. Pub. 1966, et F. Martínez: *El criterio económico . . . ,* cit. E. Antonini: *Equivalenza di fattispecie tributarie . . . ,* cit. pag. 169-71 et H.W. Kruse: *Steuerrecht,* cit. page 105, coincident en partie avec cette opinion.

53. *Instituciones de Derecho Tributario,* Madrid 1957, page 146, A. Amatucci s'exprime en termes semblables: *L'interpretazione della norma di Diritto Finanziario,* Naples, 1965, pages 126 et ss.

54. Voir, pour tous, G.A. Micheli: *"Capacitá contributiva reale e presunta",* dans Studi in Me. C. Esposito, vol. II, pages 973 et ss.

55. Nous nous sommes occupés plus particulièrement de cette question dans notre ouvrage sur *"El principio de legalidad tributaria en la Constitución española de 1978",* dans *Seis estudios sobre Derechos Constitucional e Internacional Tributario,* Edersa, 1980.

SUMMARY

The author develops two lines of argument. Firstly, he points out with respect to methodology that it is desirable that agreement be reached concerning the terminology used. This is a requirement for study of any subject and it is particularly true for the study of law. Secondly, the author gives his view on the relationship, under the provisions of Spanish law, between the taxpayer's real intention and the manner in which this is legally presented.

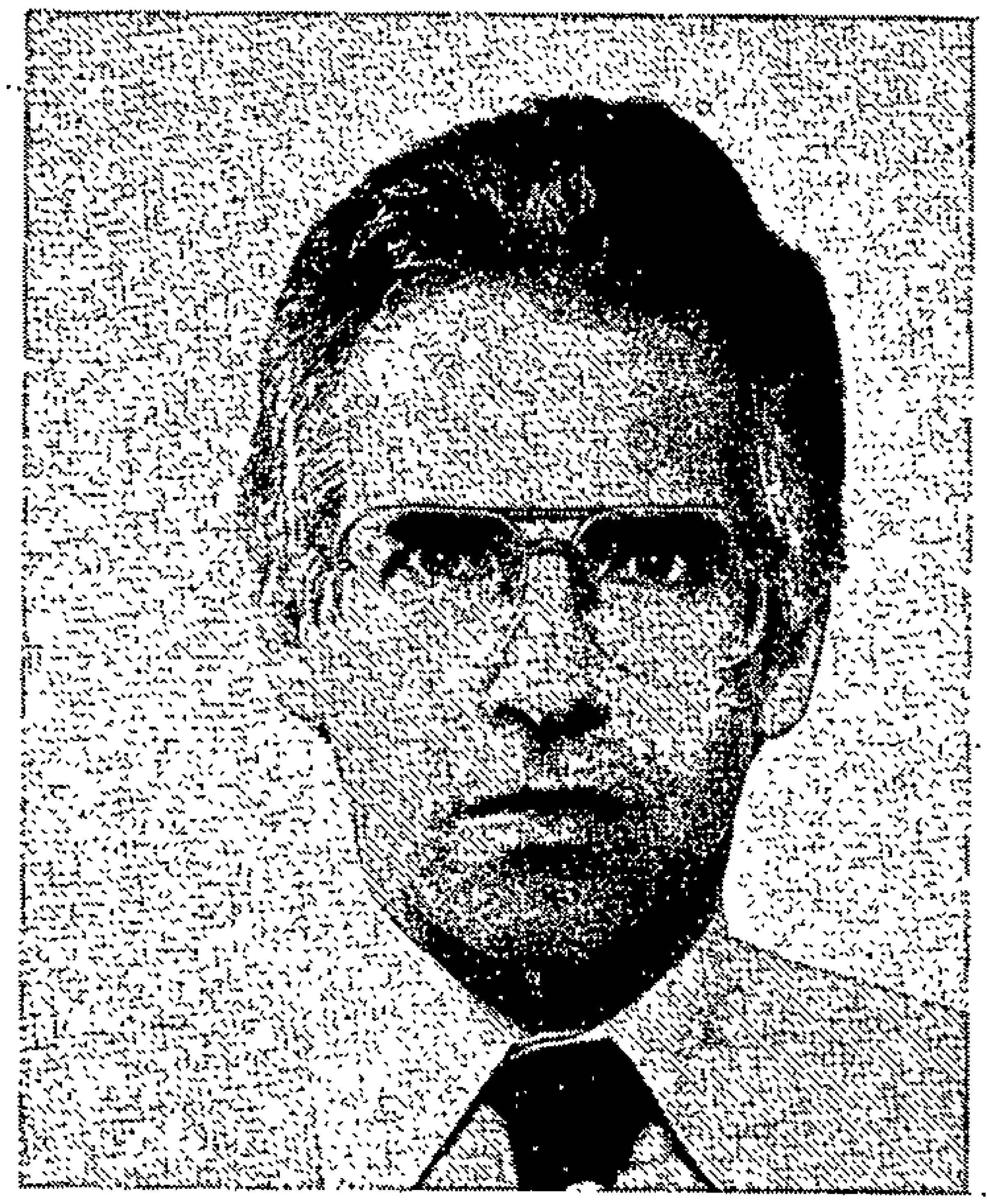
The use of private law concepts such as "fraus legis" – i.e. abuse of the law – in tax law poses delicate problems. The solutions aiming at resolving this difficult problem show that there are 5 different approaches:

1. Some persons maintain that the problem simply does not exist since they give absolute priority to the will of the parties concerned and this will should be respected in any circumstances as long as the law is not violated.
2. Other authors find that although parties are in principle free to contract and to choose those legal forms which are most convenient to them, such freedom does not exist vis-à-vis the application of tax law. They consider the economic transaction as such to be crucial and it is that transaction which should be the subject of taxation. Whether tax should be imposed is a matter of interpretation of the law and thus there is no room for the concept of abuse of the law.
3. A third group of authors maintains that to assume abuse of the law it is not sufficient that the legal forms adopted by the parties concerned deviate from the economic objective pursued, but that there should also be some intention to avoid tax.
4. Another group of authors believes that the essence of the abuse of the law is rooted in the clash between the objective pursued with the transaction concerned and the will manifested by the parties when they choose an inadequate or improper legal form to carry out their objective.
5. Finally, we may mention a fifth opinion – that of Giannini – which supplements the above theory and which describes the difficulties which arise when the facts do not coincide with the legal situation. He finds that it is imposible to find one single solution, i.e. to rely exclusively on the legal form or on economic reality. The only thing which one might do is to establish a number of guidelines

Tax Evasion

The Present State of Non-Compliance

By Nathan Boidman



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This article is an edited version of the text of a paper presented to the American Bar Association's invitational conference on income tax compliance, held in Reston, Virginia, March 16-19, 1983. The conference focused on the present situation in the U.S. and the major concerns arising out of significant increase in the degree of non-compliance with U.S. law. This paper, entitled "What can be learned from the experiences of other countries with income tax compliance problems?" (for topic 1, "The extent, nature and causes of non-compliance with Federal income and exployment taxes") provided a comparative study of the experience in some 17 other countries with non-compliance and government response thereto.

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I. INTRODUCTION AND OVERVIEW

A. Scope of paper

This paper deals to some extent with the nature and degree of non-compliance experienced in "other countries" (that is, other than the U.S.) and, assuming that every country experiences some non-compliance, to a greater extent with the response of government thereto. The fifth section of the paper summarizes "what may be learned by the U.S." from such experience and response.

Based on a Canadian frame of reference, the "experience" in 17 countries is considered. The data respecting such countries stem, in part, from a questionnaire circulated to colleagues practicing tax law in such countries.[1]

B. Some initial observations and conclusions

Some thoughts and conclusions are as follows:

- All countries experience some degree of non-compliance.
- In some countries, non-compliance stemming from omission (deliberate or otherwise) is accorded less severe sanctions than that stemming from commission: deliberate acts of falsification or destruction of records. The former is often labelled "evasion", the latter "fraud".
- In most countries, highly aggressive tax avoidance plans, based on literal interpretation of law or even perhaps relatively untenable interpretations, is not treated as non-compliance – in the sense that sanctions are not imposed.
- In this respect, it is often difficult to identify clear lines of demarcation between "non-compliance" and "tax-avoidance", although an identifiable deception or misrepresentation seems to be a common element of non-compliance.
- All countries penalize, and seek to discourage, non-compliance by way of monetary penalties.
- As well, all countries provide a possibility of personal incarceration (imprisonment) as a means of discouraging and dealing with non-compliance (particularly that involving "commission" (fraud)); some countries exhibit aggressive use of such a sanction while others manifest a reluctance to penalize offenders beyond the imposition of monetary fines.
- Some countries impose other types of sanctions, such as waiver of limitation periods or denial of deductibility of expenses related to undisclosed income, or exceptionally, as in the case of Belgium, France, and Greece, the loss of personal rights, such as a driver's permit or passport.
- In many countries, but not all, non-compliance gives rise to social stigma, which is utilized as a means of dealing with the problem through procedures to publicize the identity of offenders; as a concomitant measure, some countries encourage compliance, after the fact, through "voluntary disclosure" programs.
- Generally, non-compliance seems to be increasing, as is the response of government.
- Where borderline activities are involved (artificial schemes, offshore companies, etc.), a closer examination is required of the attitude of the courts in appreciating facts or applying doctrines (sham, business purposes, substance over form) or rules of interpretation (literal versus liberal-contextual construction of tax statutes).
- The study does identify the best or optimum approach to countering non-compliance[2] although the threat of strict enforcement of imprisonment probably would have the most dramatic effect.
- As in most areas of taxation, the response of other countries to non-compliance seems to be less elaborate and sophisticated than that in the U.S. For example, there is no evidence in any other country of specific sanctions for the "audit lottery".[3] However, most countries are devoting more resources to (and developing, rapidly, much better capability in) dealing with non-compliance.
- International cooperation, in various forms, in combatting non-compliance is increasing.

C. Distinguishing tax avoidance and non-compliance

What is meant by "non-compliance" and how is it to be distinguished from "tax avoidance" (e.g. "tax planning") which does not amount to non-compliance. In fact there are two separate issues.

- the manner in which non-compliance is to be distinguished from tax avoidance;
- the manner in which non-compliance arises, its effects, and the government responses thereto.

Although the first issue could be considered an included or necessary aspect of the investigation of the "nature" of non-compliance, within the parameters of this paper, it must be consigned to an introductory note (and revisited but occasionally) for the purposes only of establishing a context or frame of reference.

A *functional distinction* may easily be made:

- Non-compliance (at least for this paper) refers to any conduct by a taxpayer to which the response is an imposition of sanctions which go beyond merely assessing the amount of tax not paid as a result of the conduct.
- Conversely "tax avoidance" (at least for this paper) is any other type of activity or conduct by a taxpayer.

More difficult is the *conceptual distinction*. Although the element of deception or false representation (misrepresentation) may be the common ground, it is difficult to identify a comprehensive set of principles or criteria for such distinction. This is particularly so in considering the

1. Questionnaires were circulated to colleagues in the following countries: Australia, Belgium, Denmark, France, Germany, Greece, Hong Kong, Israel, Italy, New Zealand, the Netherlands, Norway, South Africa, Sweden, Switzerland and the United Kingdom. As well Canada is covered. For background purposes a questionnaire was also sent to colleagues in the United States. The respondents are listed in Appendix A. The background information respecting the U.S. was supplied by Marjorie Elkin and Susan F. Klein of the law firm of Zimet, Haines, Moss & Friedman, New York. Reference will also be made, on an ad hoc basis, to other countries such as Japan.
2. See, for example, Appendix B respecting the lack of effect in Israel of publicizing tax offenders.
3. See section II.A.5.

issue in an international context.[4]

The spectrum comprises two extremes: the overt types of non-compliance comprising deliberate falsification, destruction or misrepresentation of facts or records, at the one end, and acceptable "tax planning" at the other. The difficulties arise with respect to the middle ground of the spectrum, ranging from aggressive tax planning to negligence or omissions, the "mens rea" in respect of which may be difficult to prove.

Where the conduct or transaction is not clearly fraudulent, the two cannot be distinguished by "mens rea" or "intent". The taxpayer adopts a deliberate course of action, the purpose of which is to reduce taxes which otherwise might apply. The courts in most countries, including the U.S., Canada and the U.K., accept that it is the taxpayer's right to take positive steps to minimize or reduce liability to tax.[5] The problem can arise that thus deprived of "mens rea" as a distinguishing factor (and ignoring outright fraudulent actions), there may be a decided lack of criteria or principles to fasten upon. For example, the simple words "evade" or "attempt to evade", as in Para. 239(1)(d) of the Canadian Income Tax Act (which defines a tax offender as a person who "willfully, in any manner, evaded or attempted to evade, compliance with this Act or payment of taxes imposed by this Act"), can be concepts of variable content. This is particularly so in respect to transactions or structures having no purpose other than to reduce tax, where "sham" may be alleged or insufficiency or other defects in implementing complex tax avoidance schemes are present, or where each separate step or aspect of such schemes appear, when examined separately and out of context, to be perfectly "proper", but, in the aggregate, amount to a "fiscal nullity".[6]

As noted, perhaps the only conceptual criteria is that of deception. Mr. H. Heward Stikeman, Q.C., one of Canada's foremost tax lawyers, expressed this as follows:

> Tax evasion, being fraudulent, is ex-hypothesi intended to deceive.[7,8]

It may be difficult to distinguish non-compliance from tax planning or avoidance, but this paper presupposes the distinction.[9]

Finally, it can be noted that issues in this area evolve slowly. Almost 15 years ago, Mr. Philip F. Vineberg, dean of Canadian tax barristers, in a paper entitled "The

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4. One difficulty is simply the diversity of terminology. Another is differences in attitudinal response or reactions in different countries, arising out of different social, economic or historical factors. These are reflected to some extent in the following excerpt from a paper delivered by Egbert J. Jonker at a Canadian IFA Branch meeting held February 1982 in Toronto on the subject of "Recent International Developments to Counter Tax Avoidance and Evasion". Mr. Jonker stated:

> This presentation deals with the developments, mainly in Europe and especially in the Netherlands, on the subject of combatting international tax avoidance and tax evasion. I would focus mainly on the cooperation between states in the exchange of information. It is not easy to draw a line between evasion and avoidance. The distinction is generally made that evasion involves a limitation of tax while one remains within the law. It should be borne in mind that what is viewed as avoidance in one country could be viewed as evasion in another country. Assuming that tax evasion is always unacceptable, the OECD Committee of Fiscal Affairs has identified the kind of avoidance schemes that should be combatted.

(Egbert J. Jonker: "Recent Decisions and Accommodations of International Bodies", Seminar on Recent International Developments to Counter Tax Avoidance and Evasion, International Fiscal Association, Text of Seminar Papers, February 18, 1982 (Richard De Boo, Toronto), at page 19.)

Both the OECD and the United Nations have been engaged in studying the distinction, in different countries, between "evasion" and "avoidance". The International Bar Association sponsored a study on point, *Tax Avoidance, Tax Evasion*, published in 1982 by Sweet & Maxwell, London, comprising a survey by "a team of international rapporteurs" dealing with Canada, Denmark, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom and the United States.

5. For example, the U.K. House of Lords in *C.I.R.* v. *Duke of Westminster*, [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.

6. As in the landmark decision of the U.K. House of Lords, in a civil action, in *Ramsay* v. *I.R.C.*, [1981] S.T.C. 174, where a scheme to create a simultaneous deductible loss and exempt gain was struck down as being a "fiscal nullity". See note 47 for similar developments in other countries. With respect to *Ramsay*, see J.F. Avery Jones, "The Whole is Greater Than the Sum of its Parts", *British Tax Review* 1 at 65 (1981); and H.H. Monroe, "Fiscal Finesse: Tax Avoidance and The Duke of Westminster", *British Tax Review* 4 (1982) at 200.

7. From a paper delivered to the International Tax Planning Association, Nassau, on 10 November 1980, "How Canada Views the Bahamas and Other Tax Havens", Stikeman quotes J.R. Robertson, at present Canada's Director General of Compliance, in an article the latter wrote, "The Use of Tax Evasion and Tax Avoidance by Multi-National Companies, A Canadian View", 25 *Canadian Tax Journal* (1977) at 513: "For our purposes the line between tax avoidance and tax fraud (tax evasion) is very narrow. In Canada where the corporate setup is such that the document says one thing but the actual facts are something else, if proof can be obtained, a case of fraud would exist." Revenue Canada, in an Information Circular (No. 73-10R2), distinguished between tax evasion, unacceptable tax avoidance (not subject to sanctions), and acceptable tax avoidance (not disturbed). In *Her Majesty the Queen* v. *Myers*, 77 DTC 5278 (a decision of the District Court of the Judicial District of Calgary) where the taxpayer was convicted of tax evasion pursuant to, inter alia, subsection 239(1) of the Canadian Income Tax Act for utilizing a Swiss corporation to publish a newsletter written in Canada, the element of deception was discussed as follows at page 5285:

> In this case, the Crown has alluded to Myers' use of Euro and Inter as evidence of his knowingly intending to deceive so that the income reported by him would attract less tax than was payable under the Act. An example of the extent to which Myers went to mislead is demonstrated by exhibit 78-A (referring to a back-dated document).

And then at page 5287:

> Clearly there was a good deal more in the actions of Myers than mere "avoidance" of income tax. In my view the evidence establishes beyond any reasonable doubt that Myers willfully and deliberately followed a course of conduct to conceal his true income and deceive the income tax authorities in respect thereto.

Contrast the findings of the trial judge in *Redpath*, infra note 16 and Appendix F; see also *Dominion Bridge*, infra note 15.

8. "International Tax Avoidance" (Kluwer, infra note 9) deals, as noted in the preface, with "international tax avoidance in terms of legal notions (especially the border line between 'legitimate' and 'illegitimate' variance of avoidance)". Part XI, at pages 333-346, "Concepts and Criteria of International Tax Avoidance", focuses on "the border lines between legal or legitimate international tax avoidance" and "illegitimate or abusive avoidance" with Chapter 4 of Part XI dealing with "fiscal-juridical definitions: border line criteria", in Belgium, France, Germany, the Netherlands, the United Kingdom and the United States.

9. For a review of recent initiatives by various countries to deal with apparently unacceptable tax avoidance (as opposed to non-compliance), in particular in the international arena, see Seminar on Recent International Developments to Counter Tax Avoidance and Evasion, *supra* note 4, Nathan Boidman, "International Tax Avoidance – The Impact on Legal Systems", 35 *Bulletin for international fiscal documentation* 10 (1981) at 435 (and in particular references to the March 1980 Council of Europe Colloquy on International Tax Avoidance and Evasion); "International Tax Avoidance", a study by the Rotterdam Institute for Fiscal Studies on Tax Avoidance Measures in Belgium, France, Germany, the Netherlands, the United Kingdom and the United States, published by Kluwer in 1979 (Project Leader: Dr. J.C.L. Huiskamp; principal authors: Dr. Barry Bracewell-Milnes and Mr. M.A. Wisselink); M. Roy Saunders, "Current Trends in International Corporate Taxation, 9 *Tax Planning International Review*, 11 (1982) at 3. See also notes 33, 47, 52, 63, 64, 65 and 66 and related text.

Ethics of Tax Planning" delivered to the Tax Section of the 1968 Canadian Bar Association Conference held in Vancouver, considered the distinction between evasion and avoidance as follows:

> Apart from the rather obvious case of dishonest practices, is there any other line of distinction between tax avoidance and tax evasion? If all taxes legally due have been paid, all income has been reported, no improper deductions have been claimed, and no dishonest methods of tax savings have been adopted, does it always remain the case that the results have been achieved properly and morally? In another connection I once suggested a rather subjective test of the difference between tax avoidance and tax evasion. If you have a bright plan on how to save taxes, that is tax avoidance. If somebody else has a scheme to save taxes, that is tax evasion. It is my understanding that Canadian Crown corporations involved in international operations have seen fit to follow the practice known to private industry of interposing international corporations between parent and subsidiary where the rate of withholding tax will thereby be reduced. Some years ago I was consulted about an assessment levied against certain enterprises controlled by a United States taxpayer who wanted to avail himself of the charitable deductions in his Canadian corporations in favor of some Roman Catholic institutions in the United States. The solution was proposed to him, and readily accepted, that the Canadian companies concerned might make various contributions to recognized Canadian charities, within the same religious orbit and affiliation, who would then in turn transmit an equivalent sum to American institutions. In high dudgeon, the Deputy Minister of National Revenue at that time suggested to me that this was fraudulent and that my charitable client was very lucky that he was only facing an assessment. On the other hand, a recent report of the Canada Council – an agency of the government – points with pride to the fact that when some Canadians wanted to make substantial donations to Harvard University, before the recent change of the law made this deductible anyway, the Canada Council stepped into the breach and offered a ready medium for receipt of the money in tax-deductible category against transmission of an equivalent sum to Harvard University![10]

II. AN APPROACH TO NON-COMPLIANCE

A. Five heads to non-compliance

It would seem that there are at least 4 and perhaps 5 types of non-compliance. These are as follows:

1. Failure to declare revenue income

Has the taxpayer failed to declare the income or revenue required by applicable tax law to be declared or disclosed?

Declaration is required in self-assessment tax systems, such as that in Canada and the United States, and in most European countries (where self-assessment is not always the rule).[11] Presumably disclosure is also relevant in systems other than self-assessment systems.

Such declaration presupposes a body of law regulating matters of income tax comprising positive rules which permit a taxpayer, alone or together with qualified advisers, to "know" when income (required to be declared or disclosed) has been earned or realized by a taxpayer. In such systems the taxpayer must determine the limits of proper steps ("tax avoidance") which eliminates the need to declare a particular type of income (perhaps as a result of the form or the manner in which it has been realized); he runs the risk of misconstruing whether the matter simply involves a genuine, bona fide interpretation (as would give rise to either successful tax avoidance or such attempts which fail but which would still be characterized as "tax avoidance", albeit unsuccessful) or, rather, such as could give rise to sanctions or at least an attempt by revenue authorities to impose same.

Whether the matter arises under this first head or the others, there may be circumstances where the taxpayer and tax authority experience difficulty in distinguishing non-compliance and avoidance.[12] Drawing on the U.S. experience, reference can be had to the case of *Baskes*[13] involving highly structured offshore trusts which culminated with criminal charges laid against a tax advisor.[14] In Canada one has some difficulty in reconciling the government response in the cases of *Dominion Bridge*[15] and *Redpath Industries*.[16] In *Dominion Bridge*, Revenue Canada assessed, on a civil basis (without sanctions), an

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10. Philip F. Vineberg, "The Ethics of Tax Planning", *British Tax Review*, January-February 1969, at 35.

11. Sweden does not have a true self-assessment system: see Appendix C and report by Sten Hamberg.

12. A good illustration of the difficulty is noted by M. Roy Saunders, supra note 9, at page 3, that "some countries actually impose a penalty on pricing adjustments made by the Revenue where profits have been artificially adjusted as a result of payments to non-residents. In Belgium, Article 132 CIR imposes an addditional tax equal to the difference between 67½% and the corporate tax rate of 48% on the adjusted prices, thus giving rise to a penalty tax of 19½%. Similarly in 1982 Australia augmented its rules respecting intercompany pricing and profit shifting arrangements by adding a 10% additional tax for inadequate pricing arrangements: P.W. Allsop, "Australia – Transfer Pricing Arrangements", *Tax Management International Journal*, October 1982 at 28.
Consider the following statement of the issue, by Reuben Hasson, "Tax Evasion and Social Security Abuse – Some Tenative Observations", 28 *Canadian Taxation* (1980) at 106:

> . . . one might consider the following examples which were cited by Messrs. W.Z. Estey, Q.C. (as he then was) of the difficulty in drawing a line between tax avoidance and tax evasion at the 1968 Canadian Tax Foundation Conference:
> A taxpayer is the majority shareholder in a limited company and he places his wife on the payroll although she does not in fact work for the company. The identity of the wife is disclosed on all accounting records.
> A taxpayer forms a partnership with an infant son who makes no contribution in capital and does little or no work. If the partnership agreement is bona fide apart from these elements, is this tax evasion since it results in a lowering of the total income tax paid by the partnership as against the preceding proprietorship?

13. *U.S.* v. *Baskes*, [82-2 U.S.T.C., para. 9526], a decision of the U.S. Court of Appeal, 7th Circuit, N080-2825, 4 November 1981; see note 59.

14. A recent item noted respecting U.S. "offshore" issues was a *Wall Street Journal* report of 4 February 1983 by William M. Carley: "New York City Is Going After The Big Banks". "New York alleges that banks operating in New York City are avoiding or evading New York City tax by booking 'profitable loan deals in Nassau or other offshore sites . . ." Mr. Carley reports that, "The city, one of the few in the U.S. to tax corporate income, believes as much as 130 million in taxes is owed for years going back to the mid-1970's . . . . In response to the city's claims, a Citibank spokesman said all the bank's loans to U.S. customers are booked domestically, and so are subject to domestic taxation. As for loans to foreign countries or companies, he said they were handled by the bank's overseas staff . . . ."

15. *Dominion Bridge* v. *Her Majesty the Queen*, 75 DTC 5150 (FCTD); affirmed by the Federal Court of Appeal, 77 DTC 5367.

16. *Regina* v. *Redpath Industries Limited* and *Dominion Sugar Company Limited*, 83 DTC 5117 [Note: the writer's Firm pleaded the case on behalf of Redpath et al.]

offshore transshipment company structure as a matter of inadequate but legal tax planning (as a sham); in *Redpath Industries*, transactions involving an offshore subsidiary led to protracted criminal prosecution in which the taxpayer was acquitted, in late 1982, of any deception or sham amounting to the criminal offence of "evading tax".[17]

France and Germany have also prosecuted as tax evasion the use of transshipment companies.[18]

There are also circumstances where the declaration of income does not flow from a positive rule but rather a discretion given to the tax authorities to so find.[19] Income arising under such discretionary provisions would not properly fall within a head of non-compliance.

2. Failure to restrict deductions to those which are permitted

Has the taxpayer deducted expenses only to the extent permitted by law?

The considerations here are similar to those under the first head, although inherent herein is a positive act, a "commission" rather than an "omission".

The particular structure of the tax system can shape the extent or degree to which problems arise under this head. For example, where permissible deductions are not enumerated in a precise fashion but rather are limited by general constraints (e.g. in computing net business income for Canadian tax purposes, an expense or expenditure is deductible only to the extent it meets, inter alia, the criteria of being incurred for the purposes of "earning or producing income from business or property" or is subject to general prohibition against deductibility where of a capital nature, that is giving rise to an "enduring benefit", a criteria arising in most countries), establishing criteria for distinguishing proper deductions (or those in respect of which there is merely civil dispute) is more difficult than where only expenditures of a prescribed type of class may be deducted.[20]

Here there may be uncertainty of treatment of deductions arising from tax shelter or other tax avoidance schemes which may be sufficiently artificial so as to be totally untenable and perhaps properly categorized as non-compliance. Most countries do not appear to deal with such arrangements as problems of non-compliance (in the sense of bringing them within a regime of penal sanctions).[21]

This category can, of course, include blatant non-compliance comprising attempts to pass off as business expenses those of a personal nature, although such may also be affected by evasion-avoidance characterization issues where there are elements of both a business and personal nature.[22]

3. Failure to file a tax return

Has the taxpayer filed a tax return? On a timely basis? At all?

The failure to file a tax return [leaving aside issues on grounds of conscientious objection or other perceived political grounds] is one of the simpler approaches to non-compliance. Failure to file on a timely basis may import simple monetary fines of a nominal amount[23] or, when part of a design to not comply with tax law, may be treated as a more serious criminal tax offence.[24]

The problem of distinguishing non-compliance and tax avoidance can arise under this head. Has a person commenced or ceased to be subject to tax on the basis of being resident in a jurisdiction? There are usually many factors to be taken into account in such a determination and honest disagreement can easily arise. Blatant disregard of incontrovertible factors or situations[25] must, however, be distinguished from bona fide disagreement with tax authorities over application of the often imprecise series of criteria or factors comprising the "residence syndrome".[26]

With respect to corporate residence (a concept not relevant under U.S. tax law but the cornerstone of taxation in many countries, including Australia, Canada and many in Europe), reference may be had to the recent de-

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17. It is somewhat ironic that *Dominion Bridge* was a civil case and *Redpath* a criminal case when regard is had to the facts that, first, the offshore company in *Redpath* was capitalized with several million dollars whereas that in *Dominion Bridge* with 35 shillings and, second, the offshore company in *Dominion Bridge* had a built-in profit in its dealings with its Canadian parent company (selling goods to it at "cost plus"), whereas the offshore company in *Redpath* sold sugar to its Canadian parent at the London daily quoted rate. The Crown contended that the offshore company used to import sugar and deal generally offshore was "a 'dummy' corporation, a 'puppet' company . . ." (at page 22) and that ". . . at all times it was the accused here in Montreal, that was wholly in control of the operations and negotiations supposedly carried out by Albion (the offshore company)" (page 35). The Court found that the arrangements did not involve "subterfuge, false entries or other reprehensible acts usually perpetrated for the purpose of tax evasion" (page 29) and that it is neither deceitful nor illegal to set up what are sometimes called "puppet" or "dummy" companies . . . "so long as no deceitful or illegal means are used in so doing" (page 31). Neither did the Court find "an element of artifice, craft or strategy . . . 'wilfully and fraudulently adopted by the accused to mask some of their profits' . . ." (page 34). The excerpts of the Court's elaborate discussion of "sham" for criminal tax purposes is reproduced in Appendix E. The Crown has appealed the verdict. See also *Myers*, supra note 7.
18. See reference to an unpublished judgment of Mannheim Court, Tixier, infra note 38 at 391. See also reference therein at page 392 to the case of TGI Dijon, 12 July 1977, and Dijon, 23 June 1978, where "the criminal court convicted a French company of fraud consisting of selling products to its Belgian subsidiary through a Liechtenstein firm. The selling prices were reduced by 15% at the dispatch point in France. The goods were delivered direct to Belgium without any detour through Liechtenstein."
19. For example, under subsection 247(1) of the Canadian Income Tax Act, the Minister of National Revenue may in his sole discretion determine that an amount not otherwise required to be included in income shall be so included as part of a corporate surplus stripping arrangement in the taxpayer's income.
20. See, for example, the situation of taxpayers who earn income from employment under Secs. 5 to 8 of the Canadian Income Tax Act; contrast to employees in the U.S.
21. Supra note 6, infra note 47 and related text.
22. In this area are expenses related to travel for business, particularly if accompanied by family, and often involving privately held corporations. In Canada, the tax authorities' response can range from simple assessment to monetary penalty as a quasi-offence to prosecution for criminal tax evasion under subsection 239(1).
23. See, for example, Sec. 162 of the Canadian Income Tax Act calling for a monetary penalty equal to 5% of taxes unpaid at the date the return is due.
24. E.g., Secs. 163 and 239 of the Canadian Income Tax Act.
25. Where the taxpayer in a country such as Canada or the U.K. uses a "non-resident" company or trust, the Fisc may have difficulty in enforcing claims against the foreign entities, perhaps leading to civil or criminal actions against the shareholder; consider that element in *Dominion Bridge*, supra notes 15 and 17, *Redpath*, supra notes 16 and 17, *Myers*, supra note 7, and *Baskes* supra note 13 and infra note 60.
26. In France an untenable assertion of non-residence by a French tennis professional resulted in a fine and 6-month suspended sentence; Tixier, infra note 38 and 389.

bate in the United Kingdom, which culminated, in late 1982, with a decision to drop proposals which would replace the case law "central mind and management" test with more specific rules.[27]

4. Failure to pay taxes which are due

Has the taxpayer failed to pay taxes which he admits to and which are due?

Here the issue would comprise that of a debtor who, for whatever reason, by design seeks to avoid discharging an acknowledged obligation or one which he cannot reasonably deny.

The reluctance of one country to enforce tax claims of another under the ancient theories of sovereignty render this perhaps the most difficult non-compliance factor to deal with.[28]

There may be some expectation that the recently issued Model Treaty for reciprocal enforcement of tax claims by the OECD will eventually bring an end to such seemingly anachronistic approaches to international relations.[29]

5. The "audit lottery"

Adoption of highly untenable positions (interpretations of applicable law) as a method of non-compliance, or simply inadequate tax planning: subject to sanctions? (the "audit lottery").[30]

Essentially the taxpayer adopts a course of action to reduce taxes which is based on fundamentally untenable interpretation of applicable law and relies, for its success, on not being audited by the tax authorities. The basis for the reliance is simply the statistical probability of not being audited, due regard being had to the number of taxpayers in a given jurisdiction and the number of tax auditors or assessors available to deal with taxpayers' returns in the self-assessment system. The U.S. has responded to such an approach to non-compliance in the Tax Equity and Fiscal Responsibility Act, 1982, by adopting sanctions for certain aggressive "tax return positions".[31]

B. The "covert" vs. "overt" dichotomy?

Can non-compliance be delineated into an "overt" category comprising straightforward, unvarnished deliberate contravention of requirements under each of the first 4 heads set out above (totally illegal non-compliance) and a "covert" class cloaked in a veneer of legality or perhaps arising out of negligence or simple omission? Although the range of penalties in some countries and the differentiation made in some European countries on the basis of acts of omission vs. commission may suggest non-compliance can be delineated in this fashion, the absence of sufficiently prevalent parameters renders it devoid of functional utility. This is particularly so in the British Commonwealth countries where, for example, there is absolutely no distinction between deliberate omission vs. commission.

Some European countries do delineate non-compliance into "soft" evasion and "hard" fraud. However, the only clear rule is that most countries differentiate statutory response in a precise fashion between non-compliance and avoidance.

For example, can non-compliance be categorized as follows?:

– Situations involving claims for expenses which when subjected to close scrutiny do not withstand the criteria of being incurred for income-earning purposes. Such instance of non-compliance presumably relies for its success on the absence of examination by the tax authorities: that is the "audit lottery" – and in a country such as Canada could be subjected to the maximum sanctions.
– Non-compliance based on interpretations of law which are clearly untenable and which upon any superficial examination by tax authorities would be made out for what they are. Again, this relies more upon assumption of non-detection (the audit lottery) than any reasonable legal argument, and presumably can be considered as deceitful [and fraudulent in some countries] as other categories.
– What of artificial schemes and tax shelters which have no economic effect whatever but rely purely on multiple (usually self-cancelling) steps or legal sleight of hand such as non-recourse indebtedness or counter letters, the effect of which is a creation of a tax deduction without any economic loss, business reality or economic substance? To date it would appear that in most cases (e.g. the U.K. – *Ramsay* case[32]) such matters are dealt with as invalid attempts at proper tax avoidance and not at all as non-compliance.

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27. In the consultative document of January 1981 (21 *European Taxation* 2 (1981) at 56), the Inland Revenue proposed that companies be considered resident in the U.K. where significant elements of day-to-day business management are exercised therein, notwithstanding the place where the board of directors meet and take fundamental decisions respecting the affairs of the corporation; these rules, originally scheduled to form part of the 1981 Finance Bill, were postponed, then in a further document issued by the Inland Revenue in December 1982, present plans for amendment were dropped. See also 21 *European Taxation* 12 (1981) at 363, 22 *European Taxation* (1982) at 332, 21 *Taxes International* (July 1981), 22 *Taxes International* (August 1981), 26 *Taxes International* (December 1981), 33 *Taxes International* (July 1982), 34 *Taxes International* (August 1982), and 35 *Taxes International* (September 1982).
28. For example, in the United States such doctrine has been upheld in cases such as *British Columbia* v. *Gilbertson*, 597 F.2d 1161 (9th Circuit 1979), and in Canada in *United States* v. *Harden*, 41 S.C.R. 721 [Supreme Court, 1963]. For a good discussion see: Sanford H. Goldberg, "Foreign Investors and the United States Estate, Gift and Generation-Skipping Taxes", 35 *Bulletin for International Fiscal Documentation* 4 (1981) at 159-160.
On this matter: "Unlike most countries, Canada does not have a system of tax clearance to speak of. As a result of this indefensible gap in the law, from 1967 to 1973, 19.78 million dollars of taxes owing by 4,024 former residents was written off": Reuben Hasson, supra note 12, citing Pinos, "Take Your Money and Run", *Canadian Taxation* 1 (1979) at 43.
29. "Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims", published by the OECD in 1982. For related materials see report by Bruce Zagaris, 30 *Taxes International* (April 1982), at 4.
30. Professor Bernard Wolfman, Chairman of this topic, suggested to the writer, in response to the first draft of this paper, that in the U.S. such would properly be characterized as the "audit lottery" and may be considered a fifth head of "non-compliance".
31. Internal Revenue Code, Secs. 6661, 6670 and 6701. (TEFRA: re "audit lottery"). Penalties may apply to taxpayers and their advisors for understatement of tax as a result of certain tax shelters or reporting positions having "no substantial authority" and not adequately disclosed in a tax return.
32. Supra note 6.

In summary, while non-compliance must be distinguished from avoidance, there does not appear to be any prevalent (if not valid) dichotomy, within the class comprising non-compliance.

C. The geographic context

This paper is largely devoted to a consideration of non-compliance strictly within the domestic context, that is a taxpayer of a particular country not complying with the tax rules of that country. Non-compliance can obviously also arise with respect to cross-border transactions, foreign investors in a particular country or taxpayers thereof investing abroad[33]. In this area, however, perhaps "tax avoidance" comprises a larger concern to tax authorities, giving rise to well known unilateral and bilateral studies and programs.[34]

D. Instrumentalities of government relevant to non-compliance

In considering the experience of other countries with non-compliance, it is helpful to consider the matter in 3 segments:

- The response at the legislative level comprising, broadly, the regime of sanctions and similar factors designed to discourage and/or penalize non-compliance; the scope of this paper, however, does not entail a systematic review of legislatively granted powers of audit, investigation, search and seizure, subpoena, etc.[35]
- The response at the administrative level comprising certain aspects of the manner in which tax administrations organize their approach to dealing with non-compliance, pursuant to the rules set down by the legislature, focusing particularly on efforts to develop expertise and methods for detecting non-compliance. (As well consideration is given to steps taken by tax administrations to coordinate efforts with their counterparts in other countries.)
- The response at the level of the judiciary comprising the manner in which the courts exercise any discretions provided by law in respect to non-compliance, primarily being a question of discretion as to levying penalties, usually either monetary or incarceration; as well, consideration is given to the infrastructure for judicial proceedings in criminal tax matters.

E. Scope of investigation – questionnaire approach

Practical considerations dictated a questionnaire approach in order to augment materials readily available and develop a workable framework for the study of the experience in other countries (see Appendix A[36]). The responses of the respondents, summarized in the Appendices, underlie, in part, the comments and conclusions in the text.

III. INVESTIGATION OF BACKGROUND FACTORS

A. Overview – the nature of non-compliance

In some respects this study necessarily parallels, albeit in a truncated and general fashion, the elements and subject matter comprised in papers presented by the other speakers. Thus, as a first consideration, it is useful to consider the general economic or social context in which one finds non-compliance.

The nature of non-compliance is addressed fully by other papers for Topic No. 1. It is interesting to note, nevertheless, a comment by one writer who considers that non-compliance is simply inevitable:

> The attempt to avoid paying taxes is a reaction against the constraints imposed by any tax. It is a universal and inevitable consequence of the very existence of taxes. "Tax and evasion are as inseparable as a man and his shadow." Payment of taxes symbolizes submission. It provokes a feeling of powerlessness by creating a direct bufferless relationship between the isolated, defenceless individual and the state Moloch. It is experienced as a restriction on a person's freedom and interference with his fundamental aspirations for power and prestige. It strikes at the very core of the taxpayer's being, provoking an affective and wholly irrational reaction similar to a "child's reactions to parental domination".
>
> The psychological reactions to taxation are also to a large extent dependent on national characteristics. As Disraeli said: "Where taxes are concerned, national customs are at least as important as scientific principles."
>
> Frequent references are made to the "public-spirited attitude of the English speaking countries to taxation" as well as to the stigma attaching to tax evasion on the other side of the Atlantic. This is contrasted with the servile attitude of the Latin people, their hostility to and atrophied sense of responsibility regarding taxation. There is no doubt that national habits of thought are related to racial characteristics, but they are also influenced by a country's history and by its political, social and economic structures. In all countries

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33. See, for example, "Tax Havens and Their Use by United States Taxpayers – An Overview", a report by Richard A. Gordon, dated 12 January 1981, to the Commissioner of Internal Revenue, The Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy) [the Gordon Report] respecting the use of tax havens by U.S. taxpayers, ubiquitous issues involving Swiss or offshore banking centers, etc. See also Mr. Gordon's paper to this Conference.
34. Supra notes 4, 8, 9, 33 and infra notes 47, 61, 63, 64, 65, 66.
35. For example, under the Canadian Income Tax Act the Department of National Revenue is granted wide powers in these areas, allowing almost unlimited access to records, search and seizure, etc. It is to be expected that countries with developed non-compliance systems have rules of this type as an underpinning to the factors which will be examined. See also *James Richardson & Sons Limited* v. *The Queen*, 82 DTC 6204, where the Federal Court of Appeal upheld the Department of National Revenue's right to utilize Sec. 231 of the Income Tax Act to go on a "fishing expedition" by demanding information from a securities firm respecting all commodities transactions of all of its clients. The matter is now before the Supreme Court.
For a review of enforcement powers of various countries, see the British Inland Revenue's 1981 Report to the Keith Committee, investigating the enforcement powers of different countries. (Entry, inspection, search and seizure, etc.): Committee on Enforcement Powers: International Comparisons. For a summary of the report, see *European & Middle East Tax Report*, Issue 81-13 (6 July 1981) at 1, dealing with the United Kingdom, France, Germany, Ireland and the Netherlands.
36. Supra note 1.

there are sectors traditionally allergic to tax: agriculture, business, small trades and the professions. The situation would appear to have deteriorated in those countries with the reputation of having the most highly developed social taxation conscience in the matter of national taxation.[37]

B. Causes and general factors

The nature of non-compliance, as expressed by Tixier, is probably a good part of its cause. As well, there are factors such as high taxation and defects in private morality and ethics fostered by anonymity, inadequate government manpower for complete surveillance, remoteness from government caused by the sheer size of nations, and the relationship thereof to breakdown of community values in our society, more fully dealt with by other speakers on this topic.

The causes of tax evasion have been summarized as follows:

> I believe that tax evasion is pervasive because, first, even rich taxpayers are able to rationalize their tax evasions to themselves. After all, the loss of revenue caused by one person's evasion of tax is so minute that it is impossible to measure in any system of accounts.
> Second, I think that tax evasion is pervasive because it has become known that the number of audits carried out is extremely small [the audit lottery!]. This means that the tax evader's chances of being caught are remote. Third, tax evasion is legitimized by the fact that we condone tax avoidance. Moreover, we define tax avoidance extremely broadly. This also encourages tax evasion. [Continuing in respect to the effect "borderline tax planning"] . . . one must not be too surprised if taxpayers, with or without legal advice, are able to devise similar "borderline" cases. They may also feel that rather than devise a borderline transaction, they might just as well evade tax because the "borderline" transaction appears to them to be a case of tax evasion. (Parenthetical comments added.)[38]

C. Extent

As far as the extent of non-compliance, it is clear that it is increasing although precise "numbers" are difficult to obtain. Some data or factors to note:

- Non-compliance, the "underground economy", is becoming so widespread in Canada that it routinely receives media attention. For example, since the turn of the year, the *Financial Post*, Canada's largest news journal, has run at least 3 prominent stories on tax evasion or tax avoidance, one report indicating that the size of the Canadian underground company is between 29 and 51 billion Canadian dollars.[39]
- In a *Wall Street Journal* article dealing with new measures to counter tax evasion by Italy's shopkeepers, through requirements of maintaining locked or sealed cash registers, the related underground economy was estimated at $14-21 billion.[40]
- Three years ago, James Gourlay, the then Director-General of Compliance, Revenue Canada, estimated that "an amount equal to about 10% of reported taxes is not collected because certain people failed to file income tax returns". A further tax loss has been caused by the growth of the "underground economy".[41]
- In 1981, Norwegian tax officials undertook a renewed drive to catch tax evaders after a report by 2 experts claiming that in Norway almost 10 billion NKR of earned income was not being declared. Furthermore, the authors of that report expressed the view that "two out of every three Norwegians would be prepared to accept 'gray' money if the opportunity arose. . . ."[42]
- A tax amnesty program in Italy (see further below) estimated that there is roughly 10 to 15 billion dollars of unpaid taxes arising from non-compliance among Italy's self-employed and small business community.[43]

The nature and causes of non-compliance may not differ materially from country to country, in particular as against the U.S. experience. But, although not proven, there should be some functional relationship between its extent and the severity of the sanctions brought to bear. Do other countries experience a greater degree of non-compliance than the U.S.? If so, is the reason that the penal sanction by incarceration apparently has greater manifestation in the U.S. than in other countries?

D. Ethics and social acceptability and stigma

- Non-compliance is not perceived of as a serious social problem among the rank and file or at the community level, but within the "tax community" it is a concern.[44]
- At the general community level, non-disclosure of casual or secondary income and unreported "bartering" seems to be on the increase without social stigma, rationalized in part by economic necessity and in part by the attitude that "everybody does it". (Appendix B and related footnotes are illuminating.)
- Non-compliance may be frowned upon but does not seem to be really affected by social stigma; an interesting comparative comment with respect to fraud against social welfare programs, in Canada, was to the effect that society (and the judiciary) are generally tougher on "a poor person under financial pressure [who] obtained a benefit under a social program through fraud . . ."[45]

For a synopsis of responses, by country, see Appendix B.

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37. Gilbert Tixier (Professor of Taxation, Université de Paris, Val de Marne "Tax Evasion – An Examination", 1 *The International Contract – Law & Finance Review* 7 (1980)1 at 387.
38. Reuben Hasson, supra note 12, at 106.
39. See note 1 to the Appendices.
40. Infra note 58.
41. Gourlay, "Tax Abuse – A View from Revenue Canada", 2 *Canadian Taxation* 2 (1980) at 82.
42. Fay Gjester, "New Drive Against Evasion", *Financial Times, World Tax Report*, June 1981 at 15.
43. Infra note 56.
44. Professional groups are becoming more sensitive to their role in tax avoidance and evasion. *International Tax Reports*, No. 80-18 (25 August 1980), in a report, "Australia: Accountants Draft Tax Ethics Statement", noted that " . . . the Australians have taken a dramatic, and not entirely welcome step in issuing a draft statement on tax ethics which is stringent in its requirements". The theme of the draft is opposition to "artificial or contrived schemes which fabricate situations solely to exploit loopholes in the law".
45. "Traditionally, where a poor person under financial pressure obtains

IV. GOVERNMENT RESPONSE TO NON-COMPLIANCE

A. Overview

In general terms governments are increasing their efforts to counter non-compliance – in all areas; this also applies to "abusive tax planning or tax shelter techniques", etc. which may not amount to non-compliance (by reference to the criteria of imposition of sanctions). In recent years, most countries surveyed have or are in the process of legislative changes designed to render aggressive tax planning or use of tax shelters ineffectual: such legislation addresses such diverse problems as surplus stripping techniques, interest expense shelters, non-recourse tax-shelter structures involving either debt or limited partnerships, etc. As well, in Canada, the U.K. and the Continental countries, artificial schemes involving step transactions, lack of business purpose and (as somewhat quaintly labelled, in the Continental European countries) "abuse of law" have been rejected by the courts.[46] However, such developments or initiatives generally do not address non-compliance as such – in particular, they do not incur the range of sanctions and ancillary considerations (discussed more fully below) appropriate to what is, within the context of the framework set up herein, illegal activity.

Reference has already been made to the difficulties of distinguishing non-compliance and simple tax avoidance techniques. There can be particular difficulty in rationalizing the response to artificial tax planning devices. Are not shams within the meaning assigned by the House of Lords in the case of *Snook* v. *London and West Riding*[47] [arrangements intended to give impressions to third parties of rights and obligations which the parties to the transaction have no intention of actually creating] tantamount to illegal behaviour, meriting sanction beyond mere assessment of tax?[48]

B. Legislative response

1. General

All countries provide sanctions beyond simple assessment of income understated by reason of non-compliance.

2. Monetary penalties

Most countries fix monetary penalties as a percent of the taxes avoided. A few levy fixed penalties or amounts determined by reference to understated income; see, for example, Israel, Appendix C.

3. Imprisonment

Most countries provide the sanction of imprisonment. In some cases it is mandatory, with the sentence at the discretion of the court and not at that of the administration. The "administrative" discretion refers to circumstances where either, as in Canada, the means of prosecution is at the option of the government (the Attorney General), bringing into effect either (only) discretionary or mandatory jail sentences,[49] or, as in certain countries, the tax administration is given discretionary power with respect to the actual term of imprisonment. In most cases, the legislation provides that the court either has the discretionary power of levying or not levying imprisonment or the term thereof.

4. Limitation period

Most countries impose the sanction of loss of eligibility for limitation periods of reassessment.[50]

5. Loss of deductions

In some countries non-compliance is sanctioned by denying deductibility of related expenses.

6. Publicity

A few countries require or provide legislatively for "publicity" of non-compliance offenders.

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benefits under a social program through fraud, the courts are inclined to be much tougher with him or her than with a tax evader from the middle or upper classes who defrauds the governments of much larger amounts in the form of taxes".
Gourlay, supra note 41, at 83. Similar attitudes are noted by Reuben Hasson, supra note 12 at 98: "Furthermore, many people appear to view tax evasion with equanimity". Hasson states that Flesch, "Tax Avoidance: The Attitude of the Courts and the Legislature", (1968) *Current Legal Problems* 215, "condones tax avoidance as a response to 'penal' rates of taxation".

46. See Canadian decisions in *Atinco Paper Products Ltd.* v. *The Queen*, 78 DTC 6387; *Daly* v. *M.N.R.*, 81 DTC 5197; and *Stubart Investments Ltd.* v. *The Queen*, 81 DTC 5120; see also the U.K. decision in *Ramsay*, supra note 6.
In 1982, 5 decisions by the Dutch Supreme Court dealing with tax avoidance schemes were of particular note: (cases 20651, 20953, 20954, 20991 and 21106: see summary by Kees van Raad, "Supreme Court on Sham Transactions", *Tax Management International Journal* 82-11 (November 1982)).
In Norway, Tax News, A82-1177, see report by Jens Jacob Sander, "Norway: Substance Over Form – Capital Gains Tax", *Tax Management International Journal* 82-11 (November 1982) at 23.
In France see Philippe-Fr. Lebrun, "Alleged Disguised Sale", *Tax Management International Journal* 82-10 (October 1982) at 25.
In Australia, see Leon Gorr, "Report on Australia, 35 *Taxes International* (September 1982) at 19, respecting the decision of the Australian Supreme Court in *Federal Commissioner of Taxation* v. *Tadcaster Pty. Ltd.* (Supreme Court of Western Australia, 1982, 13 8.T.R.). The *Financial Times World Tax Report*, June 1981, reports that, "The Australian Government has taken the unusual step of introducing legislation to ensure that courts interpret taxation law in the manner which takes account of the Parliament's intentions."
Legislative responses to tax avoidance through so-called "annihilation provisions" in Australia, New Zealand, Canada, Sweden, the Netherlands and the U.K. are analyzed in "Tax Havens under Attack", Tax & Accounting Brief, Wisedene Limited, as reported in *Tax Havens & Investment Report*, 82-2 (February 1982).
M. Roy Saunders, supra note 9, reviews recent trends in anti-avoidance legislation and the trend of the Courts to ignore "a transaction or structure . . . if the sole purpose is to avoid taxes which would otherwise be levied".
See also recently published materials, supra notes 4, 8 and 9.
At least one country, Australia, responded to aggressive tax planning by introducing retroactive legislation: see Leon Gorr, "Report on Australia", 35 *Taxes International*, (September 1982) at 19 respecting the *Slutzkins'* scheme.
47. [1967] 1 All E.R. 518.
48. The Canadian case of *Redpath Industries*, supra notes 16 and 17, is probably the latest to address the issue in the context of a criminal prosecution. As such, the relevant portion has been reproduced herein as Appendix E. As noted elsewhere there is *no evidence* that any other country has adopted the U.S. approach under TEFRA respecting aggressive tax return positions whereby there may be a sanction, other than reassessment of the proper tax payable, with respect to "inadequate tax planning" of the type which clearly would not stand up to scrutiny by a court of law.
49. Subsection 239(2) of the Income Tax Act.
50. A recent example is reported by Patrick Kelly, "Belgium Report", 35 *Taxes International* (September 1982) at 21: in Belgium "special measures to combat tax evasion and avoidance were also announced: the statute of limitations in tax matters will be extended from three to five years . . . ."

7. The "audit lottery"

As noted elsewhere, it appears that no other country (than the U.S.) provides penalties for not disclosing, in a prescribed manner, aggressive tax avoidance schemes.

8. Location of books and records

There is no indication that other countries have sanctions related to the location of books and records, as those adopted in TEFRA.[51]

9. Withholding taxes

Many but not all countries seek to prevent non-compliance by withholding taxes at the source on various forms of income.[52]

The general increase in the "underground or cash economy" referred to earlier brought a direct reaction from the Australian government which proposed, in 1982, to beef up withholding provisions to apply from 1 July 1983 applicable to areas not previously covered.[53]

10. Voluntary disclosure

A few countries such as Austria,[54] France,[55] and Italy[56] seek to achieve or encourage compliance after the fact through statutory programs for voluntary disclosure, whereby tax offenders may own up to previously undeclared income and pay taxes without imposition of sanction (in some countries, voluntary disclosure programs are at the complete administrative discretion of the tax authorities without a legislative basis – in this respect, see Canada, in the next section). See also Denmark, Germany, Netherlands and Norway, Appendix C.

11. Rewards

Few countries have a legislative basis for payment of rewards to informers.[57]

12. Installment payments

Some countries seek to minimize possible non-compliance among the self-employed through the requirement of self-assessment of installment taxes.

13. Other methods

Where withholding tax procedures are unfeasible, innovative techniques are being developed. For example, it is always difficult to monitor the income of small retailers. In response to the problem, Italy recently enacted a law requiring shopkeepers to utilize "tamper-proof electronic cash registers with sealed memory banks that produce indelible printouts of sales transactions".[58] Violations of the law can be punished by imprisonment for up to 3 years. Installation of the electronic registers is required by March 1987. For some very unusual approaches, including incentive "discounts" (!) or loss of certain basic privileges (e.g. driver's permit) see Belgium, France and Greece, Appendix C.

14. Security arrangements

There is no evidence of security arrangements for payments of tax as in the case, for example, of the U.S. FIRPTA rules.

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51. Sec. 982 of the Internal Revenue Code adopted pursuant to the Tax Equity and Fiscal Responsibility Act.
52. An interesting dialogue has been taking place in the U.K. respecting withholding tax on interest and other payments to foreign investors and the effect on non-compliance. *Simons Tax Intelligence* 1982 at 534 (Notes & News), report of 22 November 1982 respecting the Consultative Committee of Accountancy Bodies in response (CCAB Memorandum TR486) to proposals "to extend the scope of the present rules on foreign dividends" of an Inland Revenue consultative document, "Consultations About The Withholding Tax Machinery Relating to Deductions of U.K. Tax at Source from Foreign and Public Revenue Dividends and Interest": *Simons Tax Intelligence* 1982 at 431. Also *Foreign Tax & Trade Briefs*, Release 283, reports that New Zealand increased withholding tax for construction activity in early 1982.
53. According to 16 *Tax News Service* No. 16 (1982), there will be deductions of tax at source from selected payments for labor and services and in connection with substantial domestic building and construction projects.
54. 16 *Tax News Service* No. 16 (1982) reports that Austria adopted a limited voluntary disclosure program ("limited tax amnesty") for tax claims arising during 1979 and 1980. In order for the disclosure to be accepted and sanctions not apply, two conditions were imposed: first, the tax authorities cannot have begun investigation prior to 1983, and second, disclosure must be made by 30 June 1983.
55. In 1982 France introduced a voluntary disclosure program pursuant to Art. 100 of the Finance Law of 1982 under which French taxpayers were entitled to report undisclosed income without liability to interest or penalties provided disclosure was made by 1 August 1982. However, it did not extend to non-compliance brought about by "fraudulent means". Furthermore, it would not apply if the investigation had already commenced. See 24 *Taxes International* (October 1981) report, by C. Guillerm-Kirk, at 22, 23 and 29; 25 *Taxes International* (March 1982) at 18, 19 as well as the commentary therein on Art. 101 dealing with disclosures respecting overseas assets.
56. In August 1982 Italy adopted a short term tax amnesty or voluntary disclosure program designed to raise roughly 5 billion dollars of tax illegally evaded for the years 1974-1981. See the *Wall Street Journal*, (23 December 1982) in an article by David Fleming, entitled "Italy's Plan to 'Pardon' Its Tax Evaders Falters Due to Complexity and Confusion" (page 13), which reports that the Italian Government "predicted the measure would bring in 4.6 billion dollars by 30 November 1982" and that Italy's 4 million self-employed and small business persons are "primarily responsible for the country's estimated 10 to 15 billion dollars lost annually in unpaid taxes". The period for disclosure was originally scheduled to comprise the period 10 November 1982 to 30 November 1982 but apparent defects in the legislation leading to uncertainty and apprehension of the effects resulted in only a small portion (700 million dollars) of the originally estimated recovery and extension of the program to 15 March 1983.
See also report in *European and Middle East Tax Report*, Issue 22-21 (File No. 1982, 5 November 1982), "Tax Amnesty – New Procedures for Settling Tax Disputes in Italy", by Giuseppe L. Rosa (page 8), providing specific information respecting the law, Decree No. 429 of 10 July 1982, ratified by Parliament under Law No. 516 of 7 August 1982, also reported on in EMETR, 1 October 1982.
57. The U.S. appears to be the only country which has a statutory basis for paying rewards to informers for tips respecting tax evaders. The following report appeared in the *Wall Street Journal*, (2 February 1983) ("Tax Report"), page 1:

> Rewarding Tattle Tales: The IRS Was More Generous Last Year To Snitches.
> You can earn up to $50,000 if you give the IRS specific information that enables it to recover additional tax from cheaters. In the year ended September 30, the IRS paid total rewards of $547,794, up 37% from the previous year and the highest since 1967. The IRS receives thousands of tips, most of which produce no rewards. Still, the number of reward claims that it approved in full or in part last year rose to 578 from 472.
> Some critics charge that the program smacks of police state tactics. But the IRS replies that it produces results. Whistle blowers' tips enabled the government to collect 11.8 million dollars last year and 14.8 million the year before, the IRS says. The size of individual rewards varies widely, depending on how valuable the IRS decided the tip is and how much it collects from the culprit; rewards of course are taxed.
> Tipsters' motives vary widely, ranging from "patriotism to revenge – and all shades in between" the IRS says.

The statutory basis thereof is Sec. 7623 of the Internal Revenue Code.
It may be noted, however, that France also has an implied statutory basis to reward informers (CGI, Art. 1825 f. This article concerns indirect taxes (contributions indirectes).
58. The *Wall Street Journal*, (10 February 1983), David Fleming: "Italy Fights Tax Evasion with a New Law Requiring Use of Electronic Cash Registers"; Mr. Fleming reports that

> The law's chief aim is to force shopkeepers to pay Italy's value added tax, a

15. Conspirators

In most countries sanctions applicable to tax offenders would also apply to conspirators, that is agents (tax advisors, corporate officers or directors, etc.) who aid or abet taxpayers in committing an offence of overt non-compliance.[59] What of requirements that tax-return preparers be identified (U.S. and Canada) to what effect?

Appendix C sets out a synopsis of reports respecting different countries.

C. The administrative response

1. Self-assessment system

Many countries utilize self-assessing systems where the taxpayer files a return and declares what he considers to be his income and tax thereon, regardless of whether there is subsequently automatic audit by the government.

2. Extent of audit

Except for Sweden, where, apparently, each return is completed by the taxpayer and the assessor, in most countries the sheer numbers preclude in-depth auditing or close scrutiny of all returns. There are, however, some countries, such as Australia, Belgium, Germany and New Zealand, which attempt to audit all business enterprises over a period of time, say 3 to 5 years.

Japan, historically, has not had a comprehensive system for auditing taxpayers.[60]

3. Approach of administration

Some countries, such as Canada, have increasingly been developing both the numerical strength and the sophistication of their technical competence and approach to tax auditing.[61]

Tax returns require fuller and more detailed disclosure.

The tax administration of some countries is centralized as far as basic approaches to interpretation and enforcement.

4. Intergovernmental cooperation

Governments are increasingly exchanging experiences and developing cooperative programs.[62,63,64]

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form of sales tax. A recent Parliamentary study found that Italy loses between 14 million and 21 million in unpaid taxes each year. The Cash Register Law spent nearly three years in Parliament before being approved. On its passage, Finance Minister Francesco Forte called the law "an act of fiscal justice". It should be noted however that there is strong opposition.

59. As in the case of *U.S.* v. *Baskes*, supra note 13, the Court of Appeal affirming an unreported decision of the District Court, finding Mr. Baskes, a U.S. attorney, guilty of "conspiring to defraud the Government . . . and aiding and abetting in the preparation of false income tax return in violation . . .", charges have been brought in other countries against conspirators: e.g. under Sec. 239 of the Canadian Income Tax Act, tax advisors who "participated in" or "conspired" to commit a tax evasion offence within the meaning of that section (see Appendix D).
Conspirators have been prosecuted for counselling the use of blatantly fraudulent tax evasion schemes involving fictitious invoices. Both Canada and the U.S. have experienced organized, widespread and blatant fictitious invoice selling shams, particularly in the garment industry, which, in Canada, have been dealt with under Sec. 239. The *Wall Street Journal*, 28 December 1982 detailed the situation in an article, "Cheating Uncle Sam: Some Garment Center Companies Fashion Phoney-Invoice Tax Swindles into an Art" (page 34).
See also Estey, Gourlay and Laidlaw, "Tax Offences – Liability of Taxpayers and Their Professional Advisors", in Proceedings of the 21st Tax Conference, 1968 (Toronto: Canadian Tax Foundation 1969), page 25.
In France complicity in tax fraud by accountants constitutes a separate and distinct offence (Art. 1772 of the CGI): Tixier (supra note 37) cites an example of the application thereof in Tribunal de la Seine, 15 December 1953, note by Blum and Blatman, Coll. Disputed Claims, DGI No. 32 page 204.
Another initiative undertaken in the U.S., at the administrative level, and not seen in other countries, is the suit against the accounting firm of Ernst & Whinney which, according to the report in the *Wall Street Journal* (15 March 1982) at page 7, saw "the Justice Department (filing) a civil suit, charging Ernst & Whinney, a 'big 8' accounting firm, with 'false, misleading and deceptive conduct' in preparing federal income tax returns for clients". The report notes that Ernst & Whinney said the lawsuit is a "misplaced" and "unwarranted" effort to "bully it into releasing confidential client files".
See also note 68 and related text.

60. In a paper to a Canadian IFA Branch meeting, J.L. Gourlay (see note 41 and related text) in describing the Pacific Association of Tax Administrators, comprising the United States, Canada, Australia and Japan, reported that:

> In Japan until right after the war, when MacArthur gave them their constitution and their income tax, record keeping was not known. To encourage the large companies particularly to keep meticulous records, as they called it, they said, "if you will keep such records, then we will allow you to file a blue return". The Revenue Department can do nothing with that return except make mathematical corrections, unless it has evidence of fraud. Since it is not doing any checking, it is never going to find any evidence of fraud. So, in effect, it was a blank cheque. I think the various examples we have been talking about at the Conference have had an impact on them. The Commissioner last time looked and said, "I think the time has come when we had better look at our Act again. Can I send some people over and can you (Revenue Canada) train them?" So we have had a couple of administrators from the Japanese Revenue Service over and we have given them a six-month indoctrination course, hoping that benefits will be down stream.

From the "From the Seminar on Recent International Developments to Counter Tax Avoidance and Evasion", page 2, supra note 4.

61. In 1980 the thrust by Revenue Canada was summarized as follows by Gourlay, supra note 42:

> From a continuing and relentless drive against tax evaders and other types of non-compliance, it has become obvious that tax evasion and tax avoidance schemes are becoming more complex and sophisticated . . . . To overcome these problems we have embarked on an even more sophisticated approach to meeting the challenges. We have, for instance, instituted, as mentioned above, an industry wide approach to tax audits. This approach has been developed and is being tested in the steel, pharmaceuticals and oil industries . . . . Some inequities are expected for an industry wide audit simply because they are largely controlled by multi-national enterprises . . . . There have been in recent years, several prosecutions of companies who have defrauded the federal government of large sums of tax by improper pricing activities . . . .
> In addition to the industry wide technique, we have also instituted a Canada-U.S. simultaneous audit program, the formal arrangement for which was signed in June 1977 . . . . The Department has started getting tougher with non-filers and an extra $170,000,000 will be collected in 1979-80 fiscal period. Our projection for the 1980-81 year is that an additional $200,000,000 will be collected.
> (See also Canada: Appendices B and D and infra notes 67 and 68 and related text.)

62. Supra note 9, references and related text. M. Roy Saunders, supra note 9, reports that it is "becoming increasingly apparent that the tax administrations of different countries are assisting each other in an effort to reduce the incidence of tax fraud and tax evasion". He refers to developments in Switzerland in January 1982 "under which Switzerland would grant unilateral international legal assistance in tax fraud. Under the provisions of this Bill it will no longer be possible to invoke the Swiss Bank Secrecy privilege in cases of tax fraud, and the Swiss authorities and the courts would be able to turn over bank documents, records of hearings, of witnesses, and other relevant documentation to the tax authorities of other countries".
However this would not apply to non-compliance stemming from omissions: see statement attributed to Dr. Werner de Capitani, Head of Crédit Suisse Legal Department, in an article published in the Spring 1982 issue of that Bank's quarterly *Bulletin*, reported on by Charles Thomas in 22 *Taxes International* (June 1982) at 13, and which is an express statement of the dichotomy discussed earlier between tax evasion and tax fraud in Europe:

> In Switzerland, tax evasion (that is under-payments of taxes as a result of omissions in the tax return) does not fall within the jurisdiction of penal law, but rather of administrative law; it is not prosecuted by the criminal courts, but by the fiscal authorities themselves. Since our international legal assistance covers crimes under penal law and not under administrative law, assistance in the case of tax evasion is out of the question. Tax fraud is a different matter altogether; this is where a taxpayer attempts to

European countries, such as France, regularly participate in two sets of arrangements (aside from those which may arise on an ad hoc basis) under double tax agreements and through the European Economic Community.[65]

5. Special non-compliance force

Some countries, such as Canada, maintain special units to deal with non-compliance, particularly of the overt type contemplated herein. In Canada, the role of the "Special Investigation Division of Revenue Canada" was described as follows by Mr. J.L. Gourlay, former head of Compliance in Canada:

> The role of Special Investigation Division in Revenue Canada is to seek out and identify tax evaders, to investigate their cases fully, and if the evidence shows a violation, to prosecute them to the full extent of the law. The aim of the program is not only to punish the individual tax evader but further to deter others who might contemplate tax evasion.[66]

At an address to the 1982 Annual Conference of the Canadian Tax Foundation, Mr. Donald D. Banks, Chief of Investigative Section, Special Investigation Division, Revenue Canada, Taxation, in summarizing the current activities of the Unit, noted that "because of limited resources, only a small number or percentage of returns can be investigated". In describing the Department's powers of search and seizure he noted that " . . . 'taxation', perhaps like most areas of society today, seems to have an increasing atmosphere of confrontation". He also advised that the Unit is increasing the attention focused on the role of tax advisors in respect to "what I will call, for lack of a better terms, 'technical' fraud". He reported that, to the extent of such type of fraud:

> We are finding that these and other accommodations, involve advisors and/or tax managers, not for the purpose of putting money in their pockets but rather over-zealously causing a corporation to evade taxes. . . . We are aware of this tendency, we are earnestly seeking out all of the facts in these situations and we intend to charge the responsible persons as well as the corporations where fraud has been committed. With the amount of tax involved on most of these transactions, the tax manager and his advisors are going to find the penalties on them personally will be quite heavy, especially so when one considers that they have not personally benefitted. The Act is quite specific in respect of officers and others who participate or acquiesce in offences and we have no intention of not enforcing it just because the penalties are heavy.[67]

In France the special anti-non-compliance unit is known as "Direction des vérifications nationales et internationales" and "direction nationale des enquêtes fiscales";[68] in the U.K., it is the "Enquiry Branch".[69]

6. Net worth assessment

Some tax administrations use "net worth assessments" as a means of detecting unreported income. In Canada, the burden of proof is on the taxpayer to dislodge the assumptions of fact made and many assessments are sustained before a court on such basis.[70]

7. Voluntary disclosures

As set out in Appendix D, many countries have non-

> mislead the fiscal authorities through active deception (usually by falsifying documents). This is a criminal offence and, as such, comes within the purview of the international legal assistance. A foreign country can expect the assistance of the Swiss authorities in the case of criminal prosecution as would be made available for a Swiss trial. Banking secrecy is by no means an obstacle. The assertion that Swiss banking secrecy fosters formality is thus absolutely false.

See also Dr. H.U. Stucki and Dr. P.R. Altenberger, "Scope of Exchange of Information Provisions – Position of Switzerland", *Tax Management International Journal* 80-11 (November 1980), at 12.

See also the Canadian case of *District Court of Florida* v. *Royal American Shows Inc.*, a decision of the Supreme Court of Canada, 18 March 1982, involving assistance by the Canadian government to the U.S. authorities with respect to alleged tax fraud in the U.S. of a travelling U.S. based carnival and the decision of the U.S. court in *Burbank & Co. Ltd.* U.S.A. v., 36, A.F.T.R. 2d 75, 6227 Cert. denied 96 S. Ct. 2647 (1976), liberally interpreting the exchange of information provisions under the U.S.-Canada treaty in order to permit the Internal Revenue Service to provide Revenue Canada with information respecting a Canadian taxpayer.

63. Investors seeking to use the Netherlands as a "stepping stone" are now required to provide full disclosure of beneficial ownership in order to obtain a ruling exempting the Dutch holding company from Dutch tax on foreign-source dividend income. Jan M. van der Beek in *International Tax Report* 82-12 (24 June 1982), "Dutch Crack Down with New Reporting/Disclosure Measures", states that such requirements, not being required by statutory authority, indicate that it has been prompted by pressure from other governments for cooperation in combatting at least tax avoidance if not non-compliance and it could indicate an "Article XVI U.S. Model Treaty" attitude developing within the Dutch tax administration. It can also be noted that the Dutch tax authorities will not grant a ruling for the use of a Dutch holding company to Canadian residents unless the arrangement has been disclosed to the Canadian tax authorities.

64. For a good review of cooperative inter-governmental programs involving Canada, the U.S. and certain other countries, see the Seminar on Recent International Developments to Counter Tax Avoidance and Evasion, supra note 4.

See also "TPI Interview (with) James L. Gourlay", 5 *Tax Planning International* 12 (1978) at 1 dealing with Revenue Canada's "thinking with respect to cross-frontier exchange of information and mutual assistance between revenue authorities".

65. See detailed review of EEC directives respecting mutual assistance in the field of direct taxation in paper by Egbert J. Jonker, supra note 4. See also D.A. van Waardenburg, "International Administrative Assistance in Tax Matters", 22 *European Taxation* (1981) at 211, who deals with the approach of France to international assistance.

The purposes of the March 1980 Council of Europe Colloquy on International Tax Avoidance, supra note 9, is stated as follows in *Financial Times World Tax Report*, November 1980 (page 11) by Laurie Watson:

> The Strasbourg-based Council of Europe and the OECD are cooperating on ways to tackle international tax avoidance and evasion and the fruit of their efforts is expected to be a multi-lateral convention on judicial and administrative mutual systems, which would be legally enforceable . . . . The only dissenting voice at the October parliamentary session in Strasbourg was one Swiss delegate who argued against the multi-lateral approach.

66. Gourlay supra note 41 at 84.

67. Donald D. Banks, "Special Investigations – 1982", a paper delivered to the 34th Conference of the Canadian Tax Foundation, Toronto 1982; this paper will be published in the Proceedings of that Conference. See also note 59 and related text.

68. Tixier, supra note 37 at page 394.

69. See also John Goldsworth, 35 *Taxes International* (September 1982) at 25, respecting the U.K.'s "Economic Intelligence Unit"; curiously Revenue Canada also has a unit by that name: see Marc Leduc in Canadian IFA Branch Seminar, supra note 4.

70. It is interesting to note that the technique has received mass media attention. In an article in the *Financial Post* by Arthur Drache, "Net Worth Assessment – Be Prepared When The Tax Man Cometh", 8 January 1983, the burden of proof factor is stated as follows:

> If you are reassessed on the basis of a "net-worth assessment", and you decide to challenge the tax man's figures, you had better be armed with powerful evidence. That's because once this procedure has been invoked by Revenue Canada, the onus is on you, the taxpayer, to show the Department is wrong.

The article concludes by noting that "net worth assessments are the major tool used by Revenue to pursue tax evaders, especially those who operate outside the law. Extraordinary stories have been told by taxpayers to explain discrepancies, some of which are believed" (by the courts that is).

statutory voluntary disclosure programs. In certain countries, such as Canada, the program is well understood and administered in a consistent fashion.

8. Informers

Some countries encourage informers on an administrative (non-statutory) basis, but few pay rewards.

9. Publicity

Many countries have administrative programs to publicize the identity of tax evaders.[71]

D. The judicial response

1. Bias

The courts in most jurisdictions do not demonstrate a bias towards either taxpayer or tax collector in respect of non-compliance, although it has been observed, in Canada, that welfare program offenders are treated more harshly by the courts than are tax offenders.[72] (See, however, comments to the opposite effect respecting Israeli courts: Appendix E.)

2. Discretions respecting interpretation

In respect to the matter of aggressive tax schemes, which are not generally subject to non-compliance sanctions, the trend of the courts to require economic reality and abandon literal interpretations and prevent "abuse of law" has already been noted.

3. The system

In most countries non-compliance cases are tried in the standard criminal courts, although Continental European countries generally have a dual system, in keeping with the dichotomy noted earlier between "evasion" and "fraud". Criminal judges are generally not informed on tax matters.

4. Burden of proof

In many countries the burden of proof of the Government is different in the case of prosecutions with respect to tax evasion, as compared with civil tax matters, e.g. in Canada in a criminal matter under Sec. 239, the Crown must prove the offence beyond any reasonable doubt, as in any penal matter before a Canadian court, whereas in civil matters, as noted earlier, the Crown can allege the assessment or the offence and the taxpayer has the burden of showing that the assessment is unfounded.

V. SUMMARY: WHAT CAN BE LEARNED BY THE U.S.

A. Overview

The following comments as to developments and approaches in other countries which may be utilized by, or are otherwise relevant to, the U.S. are based on the factors set out above in relation to the U.S. situation as reflected in the initial Conference papers circulated to the participants and the proceedings dealing with Topic 1.[73]

It was suggested during the proceedings that the U.S. had little to gain from the experience in other countries: in particular some expressed the view that although it is conceptually interesting or desirable to exchange ideas and maintain relationships (programs for exchange of views, experience, etc.) at this point in time whatever compliance problems other countries have, the U.S. has, whatever causes or effects other countries experience, the U.S. experiences, whatever the government response in other countries, the same is seen in the U.S.

Such views, although reasonably reflective of the situation, are not, in the writer's view, totally accurate. It would appear that there are certain benefits – and this section deals with these – to be derived, when dealing with the U.S. problem, from some of the developments in other countries.

It was clear from the interim papers published for the discussions and deliberations at the Conference[74] that the underlying factors have yet to be articulated to a functional level. That much work remains to be done – particularly in delineating the investigation of causes and nature, the determination of extent (measurements of non-compliance) and, ultimately, the development of means of inducing compliance or detecting non-compliance – is reflected by the announcement made at the Conference by Mr. Bernard Aidinoff, Chairman, Section of Taxation, American Bar Association, that "the American Bar Association and the American Bar Foundation are now collaborating in the preparation of a long-range study of federal income tax compliance". Notwithstanding the long term nature of the problem, participants manifested a marked desire to immediately get at solutions to non-compliance while, at the same time, trying to agree on its nature and how to measure it.

Clearly, the challenge of Topic 1, the present paper excepted, was identification of the means of understanding causes, extent and nature in such fashion as would lend itself to examining, evaluating and redefining optimum government response. However, the suggestion during the keynote addresses that a successful project would require more than a single Conference, but rather, in particular, a 2 or 3-year study, the parameters of which presumably could in a large measure stem from this Conference, obviously leaves open the question of whether there is anything to be gained from incorporating in the overall process an evaluation of developments in other countries, and particularly those which are different or novel to those identified by the paper writers and in the resultant discussions. Such possibility is explored in the balance of this section.

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71. In Canada prosecutions under Sec. 239 are published on a quarterly basis. (See also Appendix D.)
72. Gourlay, supra note 45.
73. Conference papers, published by the American Bar Association. Topic II dealt with: "Can Conventional Enforcement Measures and Procedures Be Improved and Extended to New Areas?" Topic III dealt with: "Can Additional Enforcement Measures Be Devised, and How Successful Can They Reasonably Be Expected To Be?".
74. Supra note 73; final papers, of which this paper is one, prepared for the Conference, will be published by the American Bar Association in a second volume.

B. The issues for the United States

The thrust of the other Conference papers and deliberations on Topic 1 seems to be as follows:

- *Voluntary compliance* (voluntariness) with the U.S. tax laws has never been manifest in a substantial fashion in the U.S. experience; it certainly is not on the increase, and prospects for increased compliance by reason of voluntariness are not good.
- In the absence of voluntary compliance, the focus shifts to means of increasing *involuntary compliance*. Here, the matter seems to break down into 4 factors:
  - (i) The most direct form of achieving involuntary compliance is withholding taxes at the source. According to James Henry, upwards of 90% of all compliance with U.S. tax law in the past has been achieved through this means of involuntary compliance.[75]
  - (ii) Information reporting not accompanied by withholding taxes can achieve involuntary compliance, the taxpayer reporting and paying taxes on such income as has been reported to the government, the taxpayer being on notice of such reporting.
  - (iii) The more indirect means of achieving involuntary compliance is the establishment of a far-reaching tax return assessment and audit procedure as will create a deterrent effect and produce compliance: the taxpayer in receipt of income in respect of which there has been no withholding and no reporting is faced with the likely prospect that his records will be audited; he is not certain that non-compliance will go undetected.
  - (iv) Probably the least direct and effective manner of achieving involuntary compliance is the deterrent effect of providing harsh sanctions for non-compliance augmented by substantial means of publicizing the applicability thereof to cases of successfully detected and prosecuted non-compliance. Professor Alfred Blumstein suggested that inasmuch as there is, at present, somewhat less than a 2% chance of being audited, such approach would require a substantial increase in the magnitude of penalties.[76]
- All such approaches would seem to be analogous to the "preventive" approach to crime in general described by Patrick Murphy (President, Police Foundation, Washington) in his comments as discussant of Professor Blumstein's paper. Mr. Murphy stressed the efficacy of such preventative approaches in comparison to seeking enforcement of the law and application of sanctions to committed violations.
- Where there has been neither voluntary nor involuntary compliance, the matter of recovery of taxes not paid by reason thereof is one of enforcement comprising detection through audit. Effective government audit procedures, prosecution, recovery of taxes and imposition of sanctions may also provide a deterrent effect and increase the involuntary compliance of others.

C. What can be learned from other countries?

1. With respect to voluntary compliance (voluntariness)

The lack of voluntariness in the U.S. was noted in the preceding section; compliance seems to require measures such as withholding at the source. What elements of the Swiss society underlie that country's absence of withholding procedures? (See Appendix C.) Can the U.S. learn from the Swiss experience in achieving voluntariness? While it may be unlikely that the general experience in the U.S. and most other countries (that voluntary compliance cannot be easily induced) is susceptible to substantial modification, some consideration should be given to the Swiss experience,[77] as well as that in the few other countries (e.g. France and Hong Kong) which do not have widespread withholding procedures.

Can voluntariness be increased by an appeal to social and political consciousness and responsibility and revenue funding of specific national needs? This possibility is examined by Mark H. Moore in "On the Office of Taxpayer and the Social Process of Taxpaying".[78] An initial impression, derived from the experience in the State of Israel, is negative. (See Appendices B and C.) Mr. Moore suggests "linking tax compliance to important public purposes"[79] and asks whether" . . . people are sometimes motivated by the desire to accomplish large purposes, to lend their contribution to grand causes, . . .".[80] The objective would be for compliance to be "seen as a way that America accomplishes important collective purposes rather than a drain on private initiatives and satisfactions".[81] However, one has difficulty in relying upon such an approach where the Israeli experience is considered. Here, one would think, would be one of the best opportunities for harnessing the perceived public needs for revenue to a large degree of voluntary compliance. However, as Dr. Amnon Rafael stated in his report on the situation in Israel:

> . . . in Hebrew the word "dam" means blood and the word "damin" means plural of blood or money [and] the saying is that Israelis are willing to give "dam" but not "damin". (Appendix B)

Should the U.S. consider the efficacy of amnesty of voluntary disclosure programs in other countries, such as Austria, Canada, Denmark, France, Germany, Italy,

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75. James S. Henry, "Non-Compliance with U.S. Tax Law – Evidence on Size, Growth and Composition", Conference Papers, supra note 73 at 5. He adds:

> In fact, as we shall see later in our discussion of composition, compliance rates are generally very high only for those income types like wages where there is a substantial degree of involuntariness in the reporting and collection process – either because of withholding and information reporting by third parties, or because of the obstacles the ordinary wage earner faces to doing any better on expenses than the standard deduction.

76. Alfred Blumstein, "Models For Structuring Taxpayer Compliance", Conference Papers, supra note 73 at 311.
77. With respect to the prospects for increased voluntary compliance, see Robert J. Haws, "Historical Perspectives on American Resistance to Taxation at page 157 of the Conference papers, supra note 73; Professor Tixier, supra notes 18 and 37 and related text, as well as excerpts from the report by Amnon Rafael respecting Israel in Appendices B and C.
78. Conference papers, supra note 73 at 441.
79. Moore, supra note 78 at 473.
80. Ibid.
81. Ibid.

the Netherlands and Norway, as a means of both recovering income taxes in respect of post non-compliance and bringing recalcitrant taxpayers into the mainstream of voluntary compliance with respect to the future? Don Bergherm, Internal Revenue Service, Compliance Director, in his comments as panelist for this paper noted the prevailing opposition to such an approach in the U.S. on the basis of the inequity or disincentive for those who have, from inception, complied voluntarily. As well, difficulties were discussed of identifying those disclosures which would be voluntary from those which were induced by imminent tax audit. It is suggested that the potential benefits outweigh the negative factors and that the U.S. may well learn from other countries in this area. (Respecting voluntary disclosures, see section IV.B.10, IV.C.7 and Appendices C and D.)

Finally, with respect to voluntariness, can the U.S. learn from novel approaches in France and Greece of rewarding compliance through tax "discounts"? (For details, see section IV.B.13 and Appendix C.) In fact, the convener of the Conference, Mr. Hugh Calkins, in a Conference memorandum, "Does Private Auditing Have A Role In Income Tax Compliance",[82] proposes that thought be given to a discount of, say, 3% for taxpayers who have their returns prepared by "qualified return auditors". This is essentially the program in effect in France at present. Further considerations of such proposals may be warranted.

2. With respect to involuntary compliance

(a) *Withholding tax and reporting considerations*

The efficacy of withholding measures to achieve involuntary compliance has been noted by James Henry in his paper.[83] Reference can usefully be made to the experience of countries, such as Israel and more lately Australia, Sweden, and New Zealand, in applications beyond the conventional categories of wages and some types of regular institutional payments (interest, dividends, pensions, retirement payment, etc.). Withholding techniques are being made applicable to perhaps the most flagrant and difficult area involving payments to the self-employed, often involving independent personal services or in the construction or construction-related fields.[84]

Prof. Oliver Oldman and Lavern Woods deal with indirect methods of applying taxes in "Would Shifting Emphasis to a Value-Added Tax System Relieve Tax Compliance Problems?"[85] Can the U.S. learn from the experience of a country such as New Zealand which has focused attention on shifting to indirect taxation?[86]

The U.S. already has substantial and sophisticated reporting requirements. It should, nonetheless, be able to learn and benefit from such innovations in other countries. Another example is the recent adoption of sealed cash registers for retail stores in Italy.[87]

(b) *Deterrent effect of sanctions*

Can compliance (involuntary?) be induced through the threat of more severe or a wider range of sanctions? What of the deterrent effect of wider publicity of offenders? This section briefly examines experiences in other countries in relation to proposals or explanatory analyses put forward by other paper writers.[88]

An analysis could usefully be made of the U.S. experience of applying the sanction of mandatory imprisonment in relation to the absence of same in countries such as Canada (where over, say, the past 5 years there has been no more than a handful of such cases), Hong Kong or Australia which report no incidence whatever thereof, or the experience in Germany where there is evidence of wider use. Harry Mansfield reported

> that no one really knows much about the effectiveness of sanctions. There remains the question of relative deterrent effect upon taxpayers of criminal sanctions, civil penalties and interest charges. Do santions operate mostly by influencing a taxpayer's emotional and psychological attitudes when preparing his return, or do they operate primarily by affecting his whole financial calculation by possible gains or losses?[89]

Mark Moore suggests tax evaders may "fear humiliation and loss of status if they are caught as well as the economic loss and threat of imprisonment".[90] Although the Israeli experience seems to be to the contrary, in the Scandinavian countries and perhaps to some extent in Canada there might be some evidence in support of such a theory.

The U.S. could well consider the efficacy of approaches in Belgium, France and Greece, where sanctions not only take the form of monetary fines or imprisonment but can lead to loss of civil rights such as the right to practice a profession or hold driving permits, etc. (see Appendix C). A variation of such an approach is reflected in Mark Moore's paper; he suggests:

> A more controversial idea would be to tie access to government services to honest, responsive taxpaying behaviour. This could include special privileges at national parks, faster processing of applications for driver's licenses, perhaps even making honest taxpaying a condition of receiving government loans of various types. Note that the proposal is not to grant special privileges to large taxpayers, but to *honest* and *reliable* taxpayers. The taxpayer privileges should honor citizenship and public spiritedness, not wealth. Indeed, since the aim of this system is to build individual commitment through a knowledge of the tax system, it may be desirable to exclude from the system of special privileges all those who have their tax returns prepared by others.[91]

82. Conference papers, supra note 73 at 563.
83. Supra note 75.
84. See proposals of this type by Gerald A. Feffer, Richard Timbie, Allan Weiner and Martin L. Ernst in the papers "Enforcement Proposals to Deter and Detect the Underground Cash Economy", appearing at page 479 of the Conference papers, supra note 73 and in particular that by Timbie and Weiner, "New Approaches to Tax Enforcement in the Real Estate and Construction Industry" at page 483. In respect of materials respecting the experience in the countries noted, see Appendix C as well as section IV.B.9. It should be noted that, in Australia, such measures are still in the planning stage.
85. Conference papers, supra note 73 at 519.
86. See Appendix C.
87. Supra note 56 and related text.
88. One hopes that the negative implications to be drawn from the apparent failure of Israel to induce compliance through stern sanctions and publicity does not curtail investigation of such approaches to the problem.
89. H.K. Mansfield, "The Role of Sanctions in Taxpayer Compliance", Conference Papers, supra note 73. Mansfield notes, at page 381, that 802 persons received jail sentences in 1981, in the U.S.
90. Moore, supra note 78 at 458.
91. Moore, supra note 78 at 463-464.

Finally, what can be learned from the experience of countries such as Canada, France, Israel, Italy, Norway or Switzerland, where either tax offenders are systematically publicized or information respecting the taxpayer's income is available to the public? Perhaps little, although some U.S. commentators would pursue such measures:

> The broadest idea of how to mobilize third parties to promote tax compliance is simply to make taxpaying a public rather than a private process. The records need not be publicized, but they might be made more available to public scrutiny – perhaps placed on file in a public building. Obviously, the proposal offends our commitment to individual privacy and reminds us that the real reason we support privacy so zealously is to limit a person's vulnerability to extortion and influence by both the state and his fellow citizens. But it is interesting that as staunch a protector of liberty as John Stuart Mill opposed proposals to create a secret ballot because a secret ballot would allow self-interested motives to come into play in what would be a public regarding act. . . . Moreover it is interesting that local property or tax assessments and payments are often matters of public record in ways that Federal income tax is not. This at least creates a precedent for giving public access to the tax rolls, and may provide an opportunity for a small empirical study to determine if public access to tax records increases fairness in compliance in tax administration.[92]

3. Conclusion

In summary it would seem clear that while the United States as a general matter has both the most sophisticated and substantive tax law and rules and administrative apparatus for compliance and enforcement, there is room for the U.S. to learn from the factors, approaches and experiences of other countries in developing and achieving a new strategy to increasing compliance with its tax laws.

92. Moore, supra note 78, 472-473.

APPENDIX A

QUESTIONNAIRE USED

Note: Questions V, XI (b) (c) and (d) and XII (d), posed subsequent to the initial questionnaire, were not addressed to all Respondents. (See note 1, to text, respecting countries canvassed.)

Question I

In respect to non-compliance, does your law impose the following sanctions:

(a) monetary penalties or fines;
(b) imprisonment;
(c) ineligibility for limitation periods for assessment or reassessment otherwise applicable;
(d) other (i.e. denial of related expenses, etc.).

Question II

Imposing the sanctions noted in "I", does your law differentiate between:

(a) overt tax fraud (i.e. deliberate understatement of income, deliberately not filing returns, falsifying records) . . . . If so, which sanctions?
(b) covert evasion (claiming non-existent or personal expenses or understatements arising from gross negligence) . . . . If so, which sanctions?
(c) covert evasion based on interpretations of law which are clearly untenable, or what may be termed "aggressive tax return positions"; see, for example, the new U.S. approach under the 1982 Tax Equity and Fiscal Responsibility Act . . . . If so, which sanctions?
(d) legalistic avoidance or evasion (i.e. artificial schemes or tax shelters without any economic effect or substance, for example, the U.K. case of *Ramsay*) . . . . If so, which sanctions?

Question III

Re: Monetary penalties or fines, are these:

(a) a percentage of understated tax?
(b) a percentage of understated income?
(c) other?
(d) are there any limitations to these penalties?

Question IV:

Re: Imprisonment and sentences:

(a) discretionary or mandatory?
(b) are there minimum or maximum terms?

Question V:

(The "audit lottery")

Is there any requirement (of the type recently enacted in the U.S. in the Tax Equity and Fiscal Responsibility Act, Sec. 6661) that aggressive interpretations of tax law on which tax avoidance is based be identified in tax returns so as to alert the tax authorities to such arrangements? In particular, is there a sanction for merely failing to "red flag" aggressive tax planning techniques?

Question VI

Are there voluntary disclosure procedures for tax offenders?

(a) If so, are these permanent programs or temporary programs (i.e. France and Australia)?
(b) Is the effect to waive penalties and merely impose the tax?

Question VII

Informers (tips to tax authorities):

(a) Are informers encouraged?
(b) Are there monetary rewards?

Question VIII

Publicity and social stigma:

(a) Is a social stigma attached to tax fraud in your country?
(b) Does it have high political profile?
(c) Is publicity of tax offenders used by the tax authorities as a means of achieving compliance?

Question IX

Are there withholding tax procedures for payments to domestic taxpayers as a means of achieving compliance?

Question X

Legal basis for sanctions, etc.:

(a) Are all of the above sanctions or programs provided for under statute or legal regulations?

(b) If not, which are at the initiative or at the discretion of the tax administration?
(c) If not, which are at the initiative or at the discretion of the tax courts?

Question XI

The tax courts:

(a) Do they take a positive role in the issue?
   (i) by bias in their decisions – for or against the taxpayer?
   (ii) by the manner in which discretion, if any, as to sanctions, is utilized – for or against the taxpayer?
(b) Are prosecutions for tax fraud heard before the standard criminal courts?
(c) Does the Government have a heavier burden of proof in dealing with the charge under a prosecution of straight tax fraud as opposed to other types of tax cases? For example, in Canada, in civil cases the tax authorities may make assumptions respecting facts and it is for the taxpayer to disprove those assumptions, whereas in prosecution for tax fraud the burden of proof would be on the Government to show, beyond a reasonable doubt, that the taxpayer intended to illegally avoid paying tax.
(d) Do the courts in dealing with highly aggressive tax plans apply the tax law literally or do they, instead, seek the intent and spirit as a means of defeating such approaches to tax avoidance?

Question XII

(a) Is there in-depth auditing of any tax returns? More than 50% of tax returns?
(b) Are there special audit programs by reference to industry, taxpayer groups, other?
(c) Are there special personnel within the tax administration designated to deal with non-compliance?
(d) Does the administration develop special programs to detect an apparent discrepancy between income declared and life styles noted, etc.? In this respect, does the administration use "net worth" assessments to detect undeclared income (comparing the taxpayer's net worth at the beginning of a period under investigation and at the end of the period and seeking to reconcile an estimated cost of living and other expenditures with declared income)?

Question XIII

Has your Government entered into any international programs to combat non-compliance aside from those under double tax agreements:

(a) with respect to assessment of tax?
(b) with respect to collection of tax?

APPENDIX B

EXPERIENCES OF SOME COUNTRIES: BACKGROUND FACTORS RESPECTING NON-COMPLIANCE

1. Australia
Respondents: Richard Edmonds, of the law firm of Allen, Allen & Hemsley, and Graeme Herring, of Peat, Marwick, Mitchell & Company.

– In Australia there is a somewhat ambivalent attitude to the extent that "although fraudulent evasion of tax is regarded as antisocial by the community at large, I do not think that much stigma attaches to a person who fraudulently evades tax" (Edmonds).
– Herring notes that although social stigma does not attach to persons practicing tax evasions, "attempts appear to be made to so view it by the major political parties". He also adds that "as a result of the proliferation of tax avoidance schemes in Australia over the past few years it has become a major political issue in regard to collection of revenue and acceptability of retrospective legislation. Political parties have developed well documented platforms on tax avoidance."
(See note 47 to text respecting initiatives against tax avoidance.)

2. Belgium
Respondent: Eric Osterweil, of the law firm of Oppenheimer, Wolf, Foster, Shepard & Donnelly.

– Non-compliance in Belgium seems to be widespread although "being caught at it . . . is relatively rare".
– There is much concern respecting non-compliance in the sense that it has high political profile although it is "difficult to say" whether it would bring a social stigma particularly inasmuch as, as noted, "the practice of tax fraud . . . is not uncommon".

3. Canada

– With respect to Canada, it is not at all clear that non-compliance to either category has "social stigma". The "underground economy" receives media attention, particularly as a result of the increase in "bartering": see for example the *Financial Post*, 8 January 1983, (page 8), "Tax Man Turns to Underground Economy". As well the media is interested in Revenue Canada's response to aggressive tax planning: see for example the front page story in the *Financial Post*, 12 February 1983, entitled "What the Taxman Is Up To – Tax Hunt".[1]

4. Denmark
Respondent: Robert Koch-Nielsen, of the law firm La Cour and Koch-Nielsen.

– Non-compliance has both social stigma and high political profile in Denmark.

5. France
Respondent: Paul Gélinas, of Phillips & Vineberg.

– The event of the Mitterrand government has already had the ef-

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1. With respect to the 8 January 1983 *Financial Post* article ("Tax Man Turns to Underground Economy"), by Arthur Drache, reference is made to a study by two University of Alberta academics, Roger Smith and Rolph Mirus, who estimate "the size of the Canadian underground economy as between 29 billion and 51 billion dollars". ("The gap in these numbers indicates the difficulties in quantifying the costs of tax evasion.")
In "What The Tax Man Is Up To: Tax Hunt: Revenue Canada's Investigative Net Is Spreading Ever Wider – A Lot of Taxpayers Are in for a Surprise", *Financial Post*, 12 February 1983 at 1), Gordon Pitts reports that Revenue Canada is "determined to generate more bang for its tax enforcement bucks . . . and it is . . . training its sights on carefully selected groups of taxpayers which it believes are under-reporting income or claiming dubious deductions."
See also an article in the *Financial Post* on 8 January 1983, "Revenue Canada Worried – Fewer Evasion Nabs Likely Due to Fewer Tax Auditors", by Hyman Solomon.
For some views of the current Director General of Compliance, John R. Robertson, with respect to tax evasion and avoidance by multi-nationals, see Robertson, "The Use of Tax Evasion and Tax Avoidance by Multi-National Companies: A Canadian View", 25 *Canadian Tax Journal* (1977) at 513.

fect of changing certain attitudes and responses to non-compliance.

- While non-compliance used to be a "national sport" without any real level of social stigma, it is becoming less socially acceptable.
- As a general matter, non-compliance does not have a high political profile.
- As noted in the legislative section, there is no publicity of tax offenders except pursuant to procedures authorized by the Attorney General.
- It should be noted, however, that the approach of the French tax authority has a certain detrimental effect on real fraud (see dichotomy in legislative section) in that there have been reported cases of suicides among those subjected to in-depth auditing.

6. *Germany*
Respondents: Jurgen Killius, of the law firm of Strobl, Killius & Vorbrugg, and Professor Albert Rädler, of the University of Hamburg and the law firm of Rädler, Raupack & Partner.

- In Germany "tax fraud used to be considered as constituting a gentleman's offence despite the fact that the criminal sanctions were in place already then . . . . In recent years, however, white collar crime receives more attention and this includes tax fraud" (Killius). Rädler notes that tax fraud gives rise to social stigma "but not in all social classes".
- As in other countries, non-compliance is of concern at official levels but "I don't think it has high political profile" (Killius).
- As a general matter the requirements of confidentiality preclude widespread use of publicity as a deterrent.

7. *Greece*
Respondent: George N. Stathopoulos, of International Consultants of Enterprises.

- The introduction in 1978 of a much tougher and severe set of sanctions respecting non-compliance indicates the concern of the Greek authorities respecting non-compliance in that country.

8. *Hong Kong*
Respondents: Kelly Edmison, Phillips & Vineberg, and Nellie Fong, of Arthur Andersen.

- As a general matter, "there is very little social stigma attached to tax evasion. It is common amongst business people to attempt to pay as little tax as possible and affairs are structured accordingly."

9. *Israel*
Respondent: Dr. Amnon Rafael, of the law firm of Rafael & Efrati.

- Dr. Amnon Rafael reports that "unfortunately tax evasion and fraud is not a social stigma in our country", pointing out that "in Hebrew the word 'dam' means blood and the word 'damim' means plural of blood or money (and) the saying is that Israelis are willing to give 'dam' but not 'damim'. On the other hand, "the question of tax evasion does have political profile in the sense that it is always debated".

10. *Italy*
Respondent: Bruno Gangemi, of the law firm Studio Legale Bisconti.

- In Italy tax fraud, generally, has high social stigma but it does not have high political profile.

11. *Netherlands*
Respondents: Paul H. van der Krabben, of Moret, Gudde, Brinkman International, and Kees Korteland and Jan M. van Kempen, of Loyens & Volkmaars.

- Tax fraud does not appear to give rise to social stigma unless "caught" (Van der Krabben). Korteland/van Kempen point out that "however, the newspapers and leading weeklies seek out tax fraud or legalistic tax avoidance (white collar crime) of politicians and other public authorities. Such a publication can be harmful to someone's political career."
- On the other hand, it is a matter that receives much attention at the political level (Van der Krabben). "In 1979 a report on tax fraud (quantitative and qualitative research on tax fraud: "Bijsterveld" Report) was published by a special committee on tax fraud . . . . Special committees of Parliament organized public hearings on tax fraud and prepared the discussion on this matter between Government and Parliament by way of questionnaires to be answered by the Government. Pressure is put upon the Government to take measures in the vigorous fight against fraud" (Korteland/van Kempen).
- Publicity is not utilized as a means of encouraging compliance (Van der Krabben). Further a recommendation in the Bijsterveld Report to systematically publish the names of tax offenders was opposed on the basis "of its social stigma and the violation of privacy" (Korteland/van Kempen).

12. *New Zealand*
Respondent: Warren Young, of the law firm of Barr, Burgess & Steward.

- Although "adverse social stigma is associated with offenders", public notice of "tax fraud" is "relatively rare".
- As a general matter non-compliance does not have a high profile in New Zealand.
- Publicity of tax offenders as a means of achieving compliance is used "to a limited extent only".

13. *Norway*
Respondent: Jens-Jacob Sander, of the law firm of Sander & Truyen.

- In Norway, there is a mixed situation of, on the one hand, social stigma for non-compliers but absence of high political profile.

14. *South Africa*
Respondent: Jonathan Schwarz, member of the Bars of South Africa and Alberta, Canada and based in London with the Canadian law firm of Burnet, Duckworth & Palmer.

- In South Africa non-compliance does not have social stigma in the business community.

15. *Sweden*
Respondent: Sten Hamberg, of the law firm of H. Utterstroem.

- Sweden "does not operate a true self-assessment system" which tends to mitigate non-compliance generally. In respect of the apparant low incidence of non-compliance, there is social stigma attaching thereto as well as a high political profile:

  Aggressive tax planning receives very bad press.

16. *Switzerland*
Respondents: Michael Kuhn of Dow Chemical, Europe, and Richard Pease, of the law firm of Lenz, Schluep, Briner & De-Coulon.

- With respect to Switzerland "clear obvious tax fraud" imports social stigma and that it "sometimes" has high political profile.

17. *United Kingdom*
Respondents: Jeffrey I. Green, of the law firm of Jeffrey Green and Company, and John Avery Jones, of the law firm of Speechly, Bircham, and Editor of the *British Tax Review*.

- In the U.K. non-compliance has some social stigma and, at times, high political profile.

APPENDIX C

EXPERIENCES OF SOME COUNTRIES:*
LEGISLATIVE RESPONSE TO NON-COMPLIANCE

1. Australia

- Australia rarely imposes imprisonment for taxpayers guilty of non-compliance, regardless of its type, although "one can be imprisoned for up to 4 years if one knowingly makes a false declaration . . ." (Edmonds).
- Australia also recently adopted the Crimes (Taxation Offences) Act of 1980 "which creates a number of offences, principally where arrangements are entered into with the purpose of making a company unable to meet an assessment of tax" (Edmonds). Herring notes, in this respect, that "imprisonment is available to a court in considering an appropriate penalty for a revenue related offence (e.g.: up to 5 years for making a company unable to pay its income tax liability)".
- Maximum monetary penalties range up to twice the amount of tax avoided.
- Sanctions generally are not applicable to highly formalistic-legalistic tax avoidance schemes unless "information is false or withheld . . ." (Herring). This assumed, however, "full disclosure of information is made to the tax authorities . . . (except where there is) . . . the sale of a company with current year profits without ensuring it has sufficient funds to pay its tax liabilities: this is now subject to criminal prosecution" (Herring).
- Other sanctions can include being subject to reassessment beyond the ordinary 3-year period.
- Australian law does not provide for voluntary disclosure programs or encouragement of tax informers through payments of rewards.
- In Australia employers are required to withhold taxes at source; otherwise "there are no other withholding tax procedures for domestic taxpayers". However, Mr. Edmonds reports, "the Treasurer announced in the last budget that the government intended to look at the possibility of introducing a withholding collection procedure in respect of payments to self-employed persons – designed to overcome the massive loss of revenue from the so-called 'cash' trade – but to date nothing has been forthcoming". Herring refers to this possibility: "as from 1 July 1983 persons paying independent contractors may be required to deduct an amount representing tax before payment is made." (See also note 53 to the text.)
- With respect to publicity of tax offenders, "although tax offenders may be named in the Tax Commissioner's Annual Report to Parliament, which is therefore open to public inspection, little immediate publicity is given to persons' names therein unless he or she is a person of prominence" (Edmonds). With respect to this procedure, Herring adds that "extracts of this report are often published in the newspapers".

2. Belgium

- In early 1981 the "Belgian Law of Recovery" was enacted and included tax fraud provisions. The system of penalties for tax fraud involves either fines from 10,000 to 500,000 Belgian francs and/or jail sentences of 1 month to 5 years. Those who advise on tax matters could also be subject to those penalties.[2]
- Sanctions are delineated between administrative and criminal. While administrative fines may range up to 10,000 Belgian francs, in the criminal area fines may be imposed by criminal courts of up to 500,000 Belgian francs for each separate violation. On the administrative side a penalty of 3 times the tax evaded on anything else would be imposed.
- The sanction of imprisonment is discretionary although "there was a recent flap over this point because in 1981 a Royal Decree seemed to make imprisonment mandatory in some cases, but this was subsequently clarified. R.D. No. 41, 2 April 1982".
- As in the case of France and Greece, there may be unusual penalties in the form of "forbidding an offender from carrying out his profession for up to 5 years", apparently with particular application to "persons who assist taxpayers to evade tax", who may also be subject to fines and/or imprisonment.
- Non-compliance can also lead to an extension of the statute of limitations from 3 years to 5 years, with respect to administrative penalties.
- Belgium has not adopted tax amnesty or voluntary disclosure procedures nor apparently are there procedures to encourage informers through monetary rewards. The latter situation is not all that clear: "Rumors on this subject abound, but there is no statutory or regulatory approach to informers. On the other hand, the Government has stated that it will examine information received whatever the source may be."
  Withholding tax procedures are utilized as a means of achieving compliance: "particularly on salaries and passive income". In addition, there is a "pré-compte applied to notional real estate income".

3. Canada

- Pursuant to Sec. 239 of the Income Tax Act, a taxpayer who willfully evades tax or any person who conspires in respect thereof can be subject to imprisonment of up to 5 years where the Crown has chosen prosecution by way of indictment rather than by way of summary conviction or a fine of "not less than 25% and not more than double the amount of the tax so sought to be avoided"; these penalties could be cumulative.
- There are also other lesser penalties including liability for a fine of up to 50% of tax sought to be evaded through willful failure to file a tax return under Sec. 163 of the Income Tax Act.
- There are no statutory programs for voluntary disclosures or payment of tax offenders nor for publicizing informers as a means of deterrent.
- Sanctions do not include disallowance of expenses, etc., although the normal 4-year limitation period for reassessment is lost not only with respect to willful tax evasion but as well gross negligence or "any misrepresentation as attributable to neglect, carelessness or willful default".
- Many forms of payments are subject to withholding tax, pursuant to Sec. 153 of the Income Tax Act. Self-employed individuals and corporations are required to make installments during the taxation year in respect of the liability for that year, failure of which leads, at minimum, to late payment interest charges.
- There is no statutory rule respecting informers.

4. Denmark

- Sanctions in the form of monetary penalties or imprisonment or in the form of loss of protection of limitation periods would apply to the grosser forms of non-compliance as well as untenable interpretation which amounts to gross negligence but not to aggressive legalistic or artificial tax avoidance schemes or shelters. (This pattern is seen throughout.)
- The maximum sanctions for non-complianc are monetary fines of 5 times the taxes evaded or coupled with imprisonment which can range up to 4 years and 100% of the taxes evaded.
- Terms of imprisonment are "discretionary, but in practice mandatory in gross cases".

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* See Appendix B for Respondents.

2. *European and Middle East Tax Report* No. 81-9 (May 1981). (See also notes 59 and 67 and related text.)

- If the taxpayer makes a voluntary disclosure, "any kind of punishment is reduced to one half".
- There are no statutory programs for encouraging tax informers.
- Publicity of tax fines arises "only in court cases which are always public, but sometimes without the right for newspapers to publish the name".
- Withholding taxes apply only to salaries and dividend payments.

5. France

There are some very unusual approaches to non-compliance in French law. As a general matter non-compliance may be classified and treated according to 3 levels or degrees: "la bonne foi", "la mauvaise foi" and "fraude". The sanctions, which to a large extent are at the discretion of the tax administration, are calibrated on 3 such levels, comprising relatively minor sanctions of perhaps a 10% flat penalty to possibilities of imprisonment of up to 10 years for the most virulent cases of tax "fraude". The highlights of the system are as follows:

- Monetary penalties may range from 10% for "la bonne foi" up to a flat fine of 250,000 French francs in addition to varying percentages of the tax not disclosed. Most such penalties are at the discretion of the tax administration and there can be penalties up to 150% of undisclosed tax in respect of "mauvaise foi" non-compliance, 300% in respect of "fraude".
- With respect to incarceration in the case of "fraude", sentences range from 1 to 5 years for a first offence and from 4 to 10 years for a second offence. In the case of "fraude", such an imprisonment within the limits noted is mandatory.
- The limitation period for the lesser types of non-compliance for reassessment is 4 years; in the case of "fraude", 10 years.
- In extreme cases of "fraude", the Attorney General can order that publicity take the form of a notice in Paris's 5 leading newspapers.
- There are no legislative programs to encourage or reward informers, although it may be noted, however, that France also has an implied statutory basis to reward informers (CG I. Art. 1825 f). This article concerns indirect taxes (contributions indirectes).
- There are no provisions for withholding taxes.
- France provides some very unusual sanctions in the case of tax fraud. For example, the court may order loss of a driver's licence or interdiction from the exercise of certain rights, such as practice of a profession. As well, having regard to the new rules under TEFRA, France is one of the few countries which may impose a sanction (100% penalty) for not producing a document.
- To encourage compliance there is a reduction of taxable income otherwise subject to the usual tax rates where the taxpayer is a member of and has his tax returns reviewed by a specified body of accountants. In other words, there is effectively a discount in taxes otherwise payable as an incentive to subject tax records, etc. to the audit procedures of the specified independent group.[3]

6. Germany (Fed. Rep.)

- In general terms the legislative approach to non-compliance in Germany parallels that of several other countries such as Canada in the sense that there is provision for both the customary sanctions of monetary penalties and imprisonment and the degree of severity of the sanction varies according to the degree of willfulness of the default. "Criminal fraud includes willful tax fraud for one's own benefit or for the benefit of a third party, whereas grossly negligent actions and certain other actions are treated as misdemeanors. There is no distinction between overt tax fraud and covert evasion" (Killius) and, "for example, imprisonment of up to 5 years is possible for tax fraud (but) usually only in very extreme cases, (e.g.) when taxes withheld from other people were not paid, but used for other purposes. Most prison convictions are on customs and excise taxes" (Rädler).
- Unlike other countries, monetary penalties for non-compliance, although "normally tied to the amount of the understated tax", are not a "fixed percentage" of the amount of tax evaded. "In practice this percentage ranges between 50% and 100% of the tax deficiency" (Killius). In addition, there is a maximum penalty of DM 3.6 million.
- With respect to imprisonment, an interesting statistic indicating that Germany is somewhat closer to the U.S. than other countries is that "in 1980 there was a total of 486 years of imprisonment (excluding customs and excise matters)" (Rädler). Killius adds that while the court has discretion of whether to impose a prison sentence of up to 5 years, there are circumstances, "particularly severe cases", where it may be "between 6 months and 10 years". Other sanctions include extension of limitation periods of 10 years "in the case of fraud or serious negligence" (Rädler).
- Germany is also one of the few countries with a permanent voluntary disclosure program. "The taxpayer can avoid any criminal prosecution if he voluntarily discloses incorrect or incomplete information or files such information late provided that at the time of the disclosure the Tax Office had not already discovered the fraud or, if it had already been discovered, that the taxpayer did not know this or should not have known it. If he already obtained a benefit, then the voluntary disclosure eliminates potential prosecution of the tax fraud only if he pays the deficiency within the deadline set by the tax office" (Killius).
- Germany does not have a statutory program for rewarding informers.
- Withholding tax procedures apply to "salary and dividends and not to interest". In the latter respect, Rädler notes that there is a "high percentage of non-compliance".
- As noted earlier, third party conspirators can be subjected to the sanctions noted above in respect to non-compliance activities".

7. Greece

- As in the case of France, Greece not only provides conventional sanctions of monetary penalties or imprisonment for non-compliance but as well there may be unusual sanctions of the following type:
  - Persons not reporting rental income may be prohibited from transferring the related property for a specified period of time or taking loans from certain specified banks or institutions.
  - For general tax evasion there may be a loss of the right to pay taxes in installments, participating in bidding for certain state projects, loss of the right to a driver's license for up to 12 months or loss of the right to a passport for a period of up to 12 months.
- Penalties for failing to file tax returns may range up to 1,000,000 drachmae, and for inaccurate tax returns up to 300,000 drachmae.
- Sanctions are generally applicable to not only the taxpayer involved but company directors or others in control of management, administrators in the case of partnerships, limited liability companies or cooperatives and, of particular note, Greek representatives of foreign companies, as well as certain professionals who conspire in tax evasion.
- On the other hand, it should be noted that individuals who have filed proper tax returns for a 3 consecutive year period are entitled to a 5% discount from tax relating to a business or professional income (see France for a similar concept).

8. Hong Kong

- Non-compliance in Hong Kong can be subject to monetary fines or imprisonment although the respondents note "in the history

3. In 1978, 45,000 income tax audits were carried out in France and 500 actions for tax evasion brought before the criminal court. "This relatively low figure – 700-800 in other years – is due to the Act of 19 December 1977 making prosecution in a criminal court subject to a recommendation by a Commission des Infractions fiscales (Tax Offences Commission)." (Tixier, supra note 37 (in text)

of Hong Kong not one person has ever served time in prison for tax evasion".

- Monetary penalties may range up to 3 times the amount of tax evaded as well as a fine of up to HK$10,000. The amount imposed depends on "the degree of the taxpayer's negligence/recklessness/willfulness, his degree of cooperation, the number of times the offence was repeated and the length of time since the offence".
- Although never imposed, it may be noted that Hong Kong provides for imprisonment of up to 3 years, there is no minimum and sentencing will be at the discretion of the court.
- Normally there is a 6-year limitation period for reassessment of tax returns; in the event of fraud, however, there is no limitation.
- There are no statutory provisions for tax amnesties or voluntary disclosures nor for payment of rewards to tax informers.
- Unlike most countries, "there are very few instances of withholding". For example, withholding is not required in respect of wages and salaries "except in the case where an employee is about to depart the Colony when the employee's pay for the last month must be withheld until the departing employee receives a clearance certificate". On the other hand, employees are required to provide information respecting payment of salaries and wages. There is a withholding at source on interest paid to individuals, whether resident or non-resident, on loans and deposits in Hong Kong dollars.

9. Israel

- In Israel Dr. Rafael in a lengthy report advised that "the Israeli income tax ordinance imposes a variety of penalties for non-compliance with its provisions". These can include "imprisonment, fines, imprisonment coupled with fines, denial of the setoff of otherwise deductible losses, denial of the deduction of otherwise authorized deductible bad debts, the increase of the rates of tax by imposing as a first rate a 35% rate in lieu of the 25% rate"; as well as loss of limitation periods (Sec. 145(a)(b) of the Israeli Income Tax Ordinance).
- Sec. 217 deals with lesser offences with fines of up to I£90,000 or imprisonment of up to 3 years.
- Monetary fines can comprise either a fixed amount, a percentage of understated income (Secs. 217 and 220) or a percentage of the tax (Secs. 215(a) and 218).
- Overt non-compliance is contemplated by Sec. 220 of the Israeli Income Tax Ordinance and "shall be liable to imprisonment for a term of seven years or to a fine of one million Israeli pounds or double the amount of income concealed or intended to be concealed by him or which he helped to conceal". It is to be noted that unlike most systems the monetary fines may be imposed by reference to the *amount of income* sought to be underdeclared and not merely by reference to the tax thereon.
- Imprisonment is not mandatory but rather may be applied at the discretion of the court.
- Israel does not provide, statutorily, for voluntary disclosure programs, nor are there statutory programs to encourage informers.
- "Under Sec. 228(A) of the Income Tax Ordinance, the Commissioner may publish once a year a list of all of the assessees convicted in the preceding year, by final judgment, of an offence under Sec. 220". However, Dr. Rafael reports that "it seems to have little effect".
- Israel's withholding tax system seems to be the most elaborate of any country. It applies to most forms of income including, inter alia, salaries, dividends and interest, remuneration of authors, artists, lecturers, examiners of tests and insurance agents, various payments for office services including translation, typing, bookkeeping, systems analysis and programming for computers and data processing, and payments to various types of subcontractors.
- Finally it should be noted that non-compliance (violations of any of the provisions of Part II of the Ordinance, comprising Secs. 215 to 228(A)) provides the assessing officer with a wide variety of discretionary powers of a punitive nature.

10. Italy

- Persons guilty of non-compliance in Italy may be subject to both monetary fines or imprisonment, monetary fines ranging up to 4 times the tax due, and imprisonment of up to 5 years.
- Where monetary penalties are applied, they constitute a percentage of the tax and if imprisonment is involved, it is mandatory with the length of the sentence left to the discretion of the judge.
- Mr. Gangemi points out that "cases of non-compliance which do not imply tax fraud (such as omitted filing of tax returns, omitted registration of profits, omitted declaration of profits derived from negligence) and for values exceeding 25 million lira (i.e. approximately U.S.$17,500) may be punished by all the above mentioned penalties including criminal penalties".
- Italy has had a rather well known program for "tax amnesty" (voluntary disclosure). In August 1982 the latest such legislation was adopted "which permitted settlement of pending disputes". (See note 48 (to text).)
- "Informers are not encouraged nor are there monetary rewards."
- In Italy there is also the well known program for publicity of tax offenders. "Lists of taxpayers and income declared by them are officially printed and newspapers do often publish such lists."
- Italy uses a withholding tax method of minimizing tax avoidance.

11. Japan

- With respect to the experience in Japan, a report in March 1981 in the *Financial Times World Tax Report*, "Crackdown on Evaders" (Pat Kearns at page 11), indicates the Japanese experience in line with that in other countries:

  > No country has stamped out tax evasion and Japan in an effort to crack down on evaders has announced stiffer penalties for tax offenders. The prison terms for tax evasion, presently no more than three years, will be lengthened to a maximum of five years.

- The report also notes that the sanctions include lengthening the "Statute of limitations for prosecution of income tax, corporate tax and inheritance tax and donation tax" from 3 years to 5 years and for purposes of levying "penalty taxes" the period will be extended from 5 years to 7 years. The stimulus for this thrust was the "publicity over the Lockheed scandal and other scandals" which "led to public pressure for heavier penalties".
- The report notes particular concern respecting the use of transshipment companies by Japanese enterprises:

  > Those consolidation procedure requirements also make it easy for corporations to set up tax havens and it is believed that there are more than 200 companies with 1,000 "paper" companies taking advantage of the situation. Until 1978 there were no requirements for a consolidation of subsidiaries in financial statements. Japanese companies, most noticeably trading or shipping firms, set up subsidiaries in the Caribbean and South Pacific where the local taxes were either lower or non-existent. The tax administration learned recently that 200 Japanese companies have kept about 11 billion yen income hidden in such havens.

12. Netherlands

- As a general matter non-compliance in respect of the self-assessment system respecting VAT, dividend withholding tax, wage tax and capital duty tax is treated more severely than that arising in respect of income tax; there is a distinction between "administrative fines" which can only be rejected by a tax court in the case of "clear abuse of discretion" and penalties which may only be imposed by the courts "dealing with criminal offences including tax fraud (district courts)" (Korteland/Van Kempen).
- Monetary penalties of up to 100% of tax evaded may arise, although in some instances there are fixed penalties of 20,000 Dfl.
- It is interesting to note that the Dutch tax authorities have attempted to impose sanctions in respect of legalistic tax avoidance schemes but failed. "In December of last year the Supreme Tax Court reversed a judgment of the Tax Court which had given its

consent to an administrative fine of 100% in the case of a legalistic tax avoidance matter . . . . However, the Supreme Tax Court reversed the Tax Court's decision only on the ground that it was not well founded. The case was referred to another tax court for a new decision. It is still possible that on legalistic avoidance matters a fine will be imposed. At least the administration intends to impose fines to a greater extent in these situations than in the past" (Korteland/Van Kempen).

- For fraud, there may be imprisonment of up to 4 years although there are no mandatory sentences (Van der Krabben). "Judges are becoming more aware of tax fraud and more cases are being prosecuted by the administration. It seems that penalties are becoming heavier" (Korteland/Van Kempen).
- There are permanent voluntary disclosure programs, although they may not eliminate an administrative penalty of up to 100% of taxes evaded.
- There is no program to reward informers. Korteland/van Kempen add that "the Intelligence Agency of the Administration have tried to play off taxpayers against each other in gathering evidence of tax fraud. They promise a fraudulent taxpayer immunity from prosecution in exchange for information about some other tax offenders. The district court has rejected the evidence gathered as being illegal.
- Withholding tax procedures apply to wages and dividends and there are "special measures . . . in relation to bearer saving certificates (registration and disclosure on disposition of bearer saving certificates)" (Korteland/Van Kempen).

13. New Zealand

- In line with other countries, the New Zealand government has been strengthening anti-avoidance and anti-non-compliance rules and programs. In the text increases in withholding taxes were noted . In a report in the *Financial Times*, "Tax Report, May 1982", reference was made to a New Zealand "Tax Force on Tax Reform" as having recommended massive reform of the New Zealand tax system in a final report tabled on 7 April 1982. Among the recommendations were changes to eliminate surplus stripping opportunities, loopholes, and rules to counter tax evasion or aggressive tax avoidance schemes, and a shift to indirect means of taxation.
- Warren Young reports monetary penalties of up to triple the amount of tax evaded and imprisonment of up to a maximum term of 12 months.
- The usual 4-year limitation period for assessment or reassessment is inapplicable where a return is fraudulent or otherwise misleading.
- There are no statutory amnesty programs nor rewards for tax informers.
- Withholding taxes are apparently utilized only in respect of employment income (but see note 52 to the text).

14. Norway

- Monetary fines for non-compliance comprise a percentage of the taxes evaded and terms of imprisonment are discretionary, subject to a maximum.
- There are permanent voluntary disclosure programs, the effect of which is to reduce monetary penalties to 50% of those otherwise applicable.
- There are no programs for encouraging tax informers nor are there provisions to publicize tax offenders.
- Only salaries and wages from employments are subject to withholding taxes.

15. South Africa

- Under Sec. 104 of the Income Tax Act of 1962, "conviction for tax evasion renders a conviction liable to fine not exceeding 1,000 Rand (approximately $1,000 Canadian dollars) or to imprisonment for a period not exceeding 2 years or both".
- There is also, as a monetary penalty, an "additional tax" which is "often equal to twice the tax normally chargeable".
- "Imprisonment is discretionary in all cases except where a person has been convicted of failing to provide required information and does not do so. After a reasonable time he may be imprisoned without option of a fine for a period not exceeding 3 months. Generally the maximum period of imprisonment is 2 years and there is no minimum."
- In South Africa there are no statutory programs for voluntary disclosure nor for monetary rewards for informers, although as an administrative matter "considerable use is made of informers".
- As in Australia, withholding taxes are limited to payments of employment income and certain payments to non-residents.
- There are no statutory programs for publicity of tax offenders.

16. Sweden

- The system of declaring income involving only a partial self-assessment system and close scrutiny of information provided minimizes non-compliance.
- In Sweden, Mr. Sten Hamberg reports that "there are two systems that operate in tandem and are meant to overlap", one being a system of "pure administrative sanctions" involving tax flat fee penalties; as well there is a system of criminal sanctions designed for "intentional tax fraud" which can involve imprisonment from "1 month up to 6 years for gross fraud".
- In the case of overt non-compliance, there may be monetary penalties of up to 4 times the under-declared tax, 40% for negligence.
- Mr. Hamberg reports "there are no Italian-type general amnesty periods (voluntary disclosure). Note that voluntary, positive amendments eliminate both types of sanctions if the taxpayer is quick enough to correct before he has come under investigation".
- There are no programs for rewarding informers but tax offenders are publicized, and, as previously noted, "aggressive tax planning receives very bad press".
- In respect to withholding "a new system has just been implemented from 1983, under which payments to self-employed persons are subject to withholding tax unless the recipient can prove he has registered for VAT – something which presumably proves he is under public control as to payments".

17. Switzerland

- In Switzerland "there is a clear distinction between tax fraud and tax evasion, splitting tax evasion into tax savings and tax avoidance. Only a clear tax fraud is penalized with sanctions" (Kuhn).
- Normally only monetary fines are imposed comprising a percentage of understated tax with no specific limitation thereof or in some cases "a non-refundable 35% withholding tax . . . " In respect of non-existent or personal expenses or understatements arising from gross negligence, there may be monetary fines of up to 4 times unpaid tax whereas non-compliance based on untenable interpretations or artificial schemes or shams may be treated as a tax infraction punished by fines from 20 to 20,000 francs.
- Other sanctions which may apply include denial of tax benefits and tougher requirements respecting installment payments.
- There is no statutory provision for voluntary disclosure programs, nor encouragement or reward of informers.
- Withholding tax requirements to domestic taxpayers arise "in cases of having chosen an unusual (legal) structure with the sole purpose to evade Swiss taxation (in which case) a non-refundable 35% withholding tax is levied" (Kuhn).
- The sanction of imprisonment is mandatory ". . . under the criminal code for fraud – forgery . . . unless offence is of minor gravity, in which case the court may at its discretion impose a fine; the maximum term of imprisonment is 10 years for fiscal fraud" (Pease).
- Monetary fines may range up to 6 times the unpaid tax.
- Third parties can be subject to sanctions. In an article entitled "Guarantor Liability Incumbent on Superior under Administra-

tive Penal Law With Special Reference to Punishment in respect of Tax Offences", by Professor Peter Böckli, LL.D., Basle, as translated by Ernest K. Briner of Zurich (the original appearing in "Zur Garantenhaftung des Vorgesetzten im Verwaltungsstrafrecht, namentlich bei Steuerstrafen" in "*Steuer Revue*" (January 1981), there is a detailed description of the Federal Act of 22 March 1974 relating to administrative penal law and the introduction of the so called "guarantor liability" of the superior in Art. 6(2) of the Administrative Penal Act (VStrR). This law applies to federal taxes administered by the federal authorities. It was made applicable to tax offences under Art. 130, the Swiss Tax Decree, and applies "even to those persons in the hierarchy . . . who, although not themselves involved in the tax offence, nonetheless had a supervisory obligation vis-à-vis the offender". Such persons may be "liable to criminal prosecution".

- With respect to publicity, there is none except "a public register of the taxable (not the gross) income of each taxpayer which can be used by those interested persons who have the capacity to sue".[4]

18. The United Kingdom

- Tax fraud is prosecuted under general criminal law provisions which include imprisonment and, as well, "fraud, apart from being capable of being prosecuted as a crime, also carries civil penalties with a maximum of twice the tax". Non-compliance is not generally prosecuted, "Taking the sample year, 1977/78, there were only 11 prosecutions for making false returns." (Green)
- Monetary fines could range up to 100% of understated income in the case of neglect (200% in the case of fraud). Penalties vary as between "fraud and willful default and mere neglect".
- With respect to terms of imprisonment "these are matters of general criminal law and there are in general maximum sentences for each offence. The amount is at the discretion of the court," (Avery Jones) and there are no minimums "save in cases such as forgery" (Green).
- Limitation periods may be extended, beyond the normal 6-year period.
- The U.K. does not have statutory-based voluntary disclosure programs nor those involving tax informers.
- In respect to withholding "in general all forms of income are subject to withholding although there are exceptions, e.g. rents and interest paid by individuals" (Avery Jones).
- With respect to publicity of tax offenders "because of the system of civil penalties which are either awarded by tribunal which sits in private or are in practice negotiated, the only publicity is in prosecution cases which are extremely small in number . . ." (Avery Jones).

4. For a recent comprehensive study of the Swiss response to tax fraud, see Silvio Bianchi, "Swiss Criminal Tax Law – A Survey", *Tax Management International Journal* 82-12 (December 1982) at 19.

APPENDIX D
EXPERIENCES OF SOME COUNTRIES:*
ADMINISTRATIVE RESPONSE TO NON-COMPLIANCE

1. Australia

- Australia does not systematically subject substantial returns to in-depth auditing. Herring notes, however, that "the Taxation Office is aiming at carrying out tax audits on people in business every 3 to 5 years".
- However, computer technology is being applied, for example, to "run through lists of dividends paid by public companies and check that recipients have declared dividend income in their returns" or to evaluate expense: income ratios. "It is an *ad hoc* process – no one group is subject to continuous audit" (Edmonds).
- There are special personnel within the tax administration designed to deal with non-compliance. "A Field Investigation Division of the Taxation Office operates to carry out these audits . . . " (Herring).
- Voluntary disclosure would normally avoid penalties.
- Informers seem welcome, though not rewarded monetarily.
- Publicity is not utilized as a tool to discourage non-compliance.
- The Commissioner has discretion, within statutory limits, as to the amount of monetary sanctions.
- At present Australia has not entered into any agreements or programs outside of tax treaties to deal with non-compliance. It is noted that "the Taxation Office does however have a connection with the Committee of Fiscal Affairs of OECD in that it often supplies written briefs of matters of importance to the operation of the Taxation Office . . . (and that) . . . other international bodies of which the Taxation Office is a working member include the Commonwealth Association for Tax Administration and Research, the Pacific Association of Tax Administrators and the Inter-American Center of Tax Administrators" (Herring).

2. Belgium

- An interesting aspect of the Belgian approach is that "the administration can refuse to deal with taxpayers' representatives who have participated in tax fraud except for the person who is subject to disciplining by a professional body or was appointed by a court or as a result of the provision of law".
- As noted in Appendix C, there may be some informal administrative programs for encouraging information through tax informers but there is no evidence of any formal administrative voluntary disclosure programs.
- Publicity of tax offenders does not seem to be carried out on a systematic basis either by reason of statutory provision or as an administrative matter.
- Belgium uses comprehensive auditing: "Each taxpayer can expect a full audit once every 3 years"; and "there is a special group" who deal with tax fraud cases although at this point there do not seem to be special audit programs by reference to industry, taxpayer groups, etc."
- Belgium as most other European countries participates in a number of bilateral and multilateral programs under the auspices of the EEC or the OECD.

3. Canada

- In Canada taxpayers report income on a self-assessment system and, as in the case of the U.S., the sheer number of taxpayers precludes in-depth auditing of every return. Initial or desk audits cannot and are not designed to identify cases of non-compliance.
- Revenue Canada has increasingly been developing both its numerical strength and the sophistication of its technical competence and approach to tax assessing. Through the experience and knowledge gained from files where in-depth auditing takes place, a non-statutory ruling procedure, monitoring of trends and developments through the usual facilities available generally (media publications, etc.) as well as through certain special programs and units within both head office in Ottawa and the various district offices, selective programs are designed to optimize the available manpower in identifying patterns or trends in tax plan-

* See Appendix B for Respondents.

ning and tax-shelter arrangements coming within or at least close to the covert non-compliance classification considered herein. (See also the new Economic Intelligence Unit and other ad hoc committees or groups discussed by Robert J. Dart and Marc Leduc on the "Panel Discussion on Special Industry Aspects" at the Canadian IFA Branch Meeting: supra note 4 to text.) As well, such approach provides the basis for detection or identification of the more prevalent types of covert non-compliance, generally (see the text and Appendix B).

- With respect to the Special Investigations Unit, see the text.[5]
- In Canada the basic approach to interpretation and enforcement is centralized, in Ottawa, to a considerable extent, although each district office may develop its own particular thrust or initiative based on local conditions, elements or personnel.
- Canada has developed an abundant number of cooperative programs with other countries. These are described in some detail by J.L. Gourlay in his paper at the Canadian IFA Branch Meeting in Toronto, February 1981: supra note 4 to text.
- A very useful data source in considering the Canadian experience with respect to non-compliance is a listing of prosecutions under Sec. 239 of the Income Tax Act published on a quarterly basis.[6]
- In general terms Revenue Canada has a relatively high profile within the tax and business community, as a result, in part of its publications, speeches and manner of operations, which should tend to reduce covert non-compliance.[7]
- There is an administrative "voluntary disclosure" program, reflecting Revenue Canada's "policy . . . to encourage voluntary disclosures".[8] Provided the disclosure is complete and is made prior to the commencement of an audit or investigation,[9] criminal tax evasion charges under subsection 239(1) are avoided as well as penalties under most other provisions.
- Although it is Revenue Canada's policy to encourage informers, "it is not the policy of the Department to pay rewards or remuneration for information".[10]
- As discussed in the text, Revenue uses "net worth" assessments as a basis for identifying probable instances of undisclosed income and supporting assessments in the courts.
- As noted in Appendixes C and E, the Crown's choice of proceedings determines whether a conviction is subject to mandatory imprisonment.

4. Denmark

- In Denmark, there are strong and continuous auditing procedures. More than 50% of tax returns are subject to in-depth audit, audit programs are designed by reference to industries, etc. and there is special personnel to deal with non-compliance.
- As noted in Appendix C, Denmark has a statutory voluntary disclosure program; 50% remission.
- As in the U.K., publicity only arises in the case of, and in accordance with factors respecting, court proceedings.
- Informers are not encouraged.
- Denmark has not only entered into cooperative programs with other countries dealing with non-compliance but may extend these to assistance in collection of tax at least for the other Nordic countries.

5. France

- Most taxpayers will be audited at least once every 7 years in a relatively in-depth fashion, companies every 3 years.
- The administration uses industry or other sector audits selected on the basis of random and/or analytical factors and there is a special unit of the administration designed to deal with systematic tax fraud.
- Informers are encouraged and are often unofficially rewarded.
- As noted in the text, France had a temporary (and statutory) voluntary disclosure–tax amnesty program. Tax issues are normally negotiated and settled with tax inspectors. Very few cases go to court and there are inherent "voluntary disclosure" aspects in this approach.
- Net worth assessment techniques are utilized. Furthermore, tax returns require disclosure of ownership of assets (such as yachts, etc.) as might disclose a life style not consistent with declared income.
- The extent of in-depth auditing and the effectiveness thereof has become a political issue as it has, apparently, driven certain tax evaders to suicide.

6. Germany (Fed. Rep.)

- As in certain other countries, in Germany "there is in-depth auditing of all tax returns of major businesses" (Killius). Rädler notes that such audits are at "3 or 4-year intervals". However, such is not the case in respect to individual taxpayers where "only the very high income tax bracket taxpayers are audited and only sporadically" (Killius).
- The German audit force is divided into specialized units for specific industries. As well "there are specific tax fraud groups attached to centralized tax offices which go out everywhere in Germany and which have most of the powers granted the public prosecutor under the Code of Criminal Procedure" (Killius). This special criminal investigation service comprises roughly 800 men (Rädler).
- As with other European countries, Germany participates in cooperative programs under the auspices of the EEC and double tax agreements. As well, it carries out simultaneous audits with the U.S. and has special agreements with Austria and Sweden (Rädler).

7. Hong Kong

- In Hong Kong "all tax returns are reviewed and agreed upon by the taxpayer and the Inland Revenue Department".
- There is a special investigation section to deal with non-compliance and "special audit groups for major industry categories, such as finance, shipping, trading and manufacturing".
- Although, as noted in Appendix C, there is no statutory provision for voluntary disclosure, there is a procedure known as the "Betterment Statements". Where the authorities detect that a Hong Kong resident "is living with a lifestyle that leads the Government to believe that such person must have had significant income in the past few years and yet he has paid little or no income tax, he is asked to explain how he was able to accumulate his assets". This leads to renegotiation and estimation of undeclared income in respect of which taxes and penalties are paid.
- Hong Kong has no international tax agreements nor any other type of programs for international cooperation for combatting tax evasion.

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5. Information Circular 73-10R2: infra note 10.
6. Information Circular 73-10R2, infra note 8.
7. See Appendix B: Canada.
8. Revenue Canada Information Circular No. 73-10R2 "Tax Evasion and Tax Avoidance", dated 24 April 1978, at paragraph 42. This Information Circular sets out, inter alia, the voluntary disclosure program.
9. The disclosure will be considered voluntary when it cannot be related by the Department "in any way to the investigation it has commenced into a taxpayer's affairs, either directly by contacting the taxpayer, his representative or his employees for the purpose of verifying or auditing his return or his records, or indirectly by contacting third parties for the same purposes" (Paragraph 43).
10. IC 73-10R2, supra note 8 at paragraph 10, generally sets out the manner in which the Special Investigations Unit conducts its operations (replying upon information stemming from normal audit procedures, investigation of the affairs of other taxpayers, information from collection officers, "planned programs through which an occupation or trade is surveyed and information provided to audit staff or investigators for verification by cross-checking to a taxpayer's records or returns", public information (newspaper reports, public records, observation of style of living, or any unusual circumstances which attract attention) and, as noted, from informers).
Paragraphs 10 through 41 of the Circular set out in detail the method of operations of Special Investigations. Also see the text.

8. Israel

- Dr. Rafael reports that a "certain percentage of returns" are selected by sample and then "audited extensively".
- Selective industry and taxpayer approaches are utilized.
- The Israeli administration maintains "two special departments which deal with non-compliance" and the police are also involved in investigating fiscal crimes. There is an "intelligence department, which seeks out information and sends it to the appropriate assessing officers". As well, "the second is the investigation unit which carries on special investigations in order to seek compliance with provisions of the ordinance".
- With respect to international cooperation, Dr. Rafael reports that "Israel is not a party to any special international program with respect to combatting non-compliance aside from the usual treaties for the prevention of double taxation which, for the most part, provide for an exchange of information between governments".
- Net worth assessment procedures are used.
- The assessing officer has much discretionary authority to apply sanctions. For example, he can deny deductions (otherwise permissible) or certain low rates of tax, impose or vary fines or interest (Secs. 189 and 192 of the Ordinance).
- There are "special 'commando' units, who raid . . . enterprises in certain areas . . . (which) . . . achieve great publicity".
- Furthermore, respecting publicity, Sec. 228(A) provides for publicity of tax evaders. However, Dr. Rafael states that ". . . it seems to have little effect".
- "Informers are encouraged to a certain extent for they are usually rewarded 10% (tax-free) of the amount recovered . . ."
- There is an informal voluntary disclosure program lacking, however, in contrast to Revenue Canada's approach, clear assurance of amnesty from prosecution.

9. Italy

- Italian tax authorities carry out in-depth audits of returns relating to professional and business income:

  As well there are special audit programs by reference to industry and taxpayer groups and special personnel within the tax administration designed to deal with non-compliance.
- Italian publication of tax offenders, through newspapers, is well known.
- Informers are not administratively encouraged (or, as noted elsewhere, there are no statutory provisions).
- There appear to be no administrative voluntary disclosure programs (see text and note 56 respecting statutory tax amnesty of August 1982).
- Mr. Gangemi reports that Italy has entered into cooperative programs with other governments within the context of the European Economic Community. (See the extensive report on such activities by Egbert Jonkers in his paper to the Canadian IFA Branch Meeting in February 1981 in Toronto: supra note 4 to text.)

10. Netherlands

- The administration has discretion as to whether or not to remit penalties.
- Generally there is no widespread auditing of tax returns, although the tax authority utilizes special audit programs as well as special compliance personnel (Van der Krabben). It is also to be noted that "local tax offices are allowed to have experiments by way of in-depth audits for selected taxpayer groups . . . At the moment the Administration is developing new auditing programs, e.g. short audits based on invoices, branch audits (gathering information on specific projects, profits, calculations, etc.). Recently special auditing programs have been carried out in relation to restaurants and bars, dentists, real property brokers (and search of owners of foreign real property), refunds received by employers from life insurance companies, etc." (Korteland/Van Kempen).
- The Netherlands participates in a wide range of cooperative programs with other governments, including the "Benelux treaty with regard to execution of all sorts of claims" (Van der Krabben).

11. New Zealand

- Publication of tax offenders is sometimes used as a means of inducing voluntary compliance.
- There is an administrative voluntary disclosure program, "at the discretion of the Commissioner". At present The Inland Revenue has adhered to such a program; penalties may be waived at the discretion of the Commissioner and "the usual policy is to limit penal tax to 7½% per annum on the tax evaded and not to impose fines or publish names of offenders".
- The tax authorities aim to "examine the returns of all business taxpayers in-depth once every 5 years".
- Audits are designed by reference to industry or taxpayers and there is a specialized group to deal with tax fraud cases.
- The net worth assessment of detecting non-compliance is employed.
- New Zealand does not enter into any inter-governmental programs for assistance except through double tax agreements.

12. Norway

- In Norway tax returns are not routinely subject to in-depth auditing, although compliance surveillance by the tax authorities includes programs designed by reference to different industries, etc. However, the administration does not maintain personnel specifically to deal with non-compliance per se.
- As noted in Appendix C, Norway, as Denmark, has a statutory voluntary disclosure program: 50% of penalties remitted.
- Neither publicity nor rewards to informers are used.
- Norway does, as in the case of Denmark, maintain cooperative programs for combatting non-compliance and assistance in collection of tax.

13. South Africa

- There is in-depth auditing of tax returns, but less than 50% thereof. Manpower is a problem: Mr. Schwartz suggests that "the Inland Revenue are currently very undermanned and there has even been a suggestion that individuals undergoing compulsory military service who are accountants might be put to work for the tax administration in helping with its manpower problems. This suggestion has not been implemented to date".
- While there appears to be no special audit program by reference to industry, etc., the South African tax administration maintains special personnel to deal with non-compliance.
- Although informers are encouraged, rewards are "highly exceptional".
- There appear to be no voluntary disclosure programs, even at the administrative level.
- Publicity is not used.
- The authorities have "a fair amount of discretion" to remit penalties or "make agreements with taxpayers".
- There appear to be no special programs for international cooperation.

14. Sweden

- "Very few returns are really audited, but a majority receive requests for further and more particulars."
- With respect to audit programs or personnel, special efforts are made "in principle, although true field audits are far lower than in e.g. the U.S. or Germany".
- Voluntary disclosures, made before any investigation commences, eliminate sanctions. (This appears to be an administrative program.)
- "No informers exist."
- Publicity is utilized.

– Mr. Hamberg reports that, aside from the "inter-Scandinavian Treaty, there is, in respect to cooperative programs, nothing outside standard treaties".

15. Switzerland

– In Switzerland "in-depth audits do take place only in cases of substantial suspicion of tax fraud" (Kuhn).
– There appear to be no special audit programs by reference to industry taxpayer groups, etc.
– Since 1981 the Federal Swiss authorities have maintained an "investigation department staff" for "committed tax fraud". In other cases "Cantonal authorities are involved" (Kuhn).
– With respect to international programs, Switzerland grants legal assistance to other countries under double tax treaties. As well there is the 1962 Decree for Misuse of Double Tax Treaties and a "Treaty of Legal Assistance" between the U.S. and Switzerland (mainly directed against organized crime).
– There is also "a new law for international legal assistance which became effective as of 1 January 1983", and "under certain conditions Switzerland offers to grant legal assistance in case of revenue fraud, which softens a little bit the former strict position. At present there has been no experience with this new law" (Kuhn).[11]
– Other approaches include more frequent audits, less willingness by tax authorities to agree on advance rulings, late payment charges and a tougher burden of proof, in response to non-compliance.
– There is no publicity per se but "in each community there exists a public register of the taxable income (not the gross income) of each taxpayer which can be used by those interested persons which have the capacity to sue" (Kuhn).

16. U.K.

– Roughly 1% or 2% of business tax returns are subject to in-depth audit.
– Although there are no special audit programs by reference to industry, taxpayer groups, etc., "the Revenue issue for their own purposes particulars about various types of businesses which are therefore more likely to be audited than others" (Avery Jones).
– In the U.K. there are certain "head office units which deal particularly with non-compliance", e.g. "the Enquiry Branch, which deals with the fraud cases" (Avery Jones) as well as the "Special Office" of the Inland Revenue for "investigation of different types of tax avoidance or evasion or suspected avoidance or evasion, in relation to different industries" (Green).
– Voluntary disclosure "would be a factor taken into account in mitigating the penalties" (Avery Jones) although the "concept of a tax amnesty is strictly speaking not known in the U.K." (Green).
– Informers are "not particularly encouraged" (Avery Jones).
– Publicity is not used, although prosecutions may be publicized in accordance with the usual factors respecting criminal proceedings.
– International cooperation outside of treaties comprises a joint (simultaneous) audit program with the United States as well as "exchange of information within the EEC which could probably be done under double taxation agreement anyway". No such programs specifically deal with "collection of tax" (Avery Jones). EEC and OECD programs are in the development stage (Green).

11. See note 62 to the text.

APPENDIX E
EXPERIENCES OF SOME COUNTRIES:*
THE JUDICIAL RESPONSE TO COVERT NON-COMPLIANCE

1. Australia

– Richard Edmonds reports that "since about 1980 the courts have taken a more cynical attitude towards tax avoidance schemes, preferring to consider the substance rather than the mere form of the arrangement. Where there is no tax avoidance scheme involved, there is no discernible bias in their decisions."
– Herring notes that "the courts' discretion is exercised in order to protect the Revenue, but it is generally exercised in a fair and consistent manner . . .".
– In Australia tax fraud is prosecuted before the standard criminal courts and "the case must be proved by the Crown beyond reasonable doubt, i.e. the criminal standard prevails".

2. Belgium

– Belgium does not have separate tax courts for criminal prosecution; they are generally "handled by the Courts of Appeal when the Government decides to press a case beyond the administrative level or if a taxpayer whishes to go to Court".
– As in most countries, the burden of proof in criminal cases is indeed heavier than in non-criminal cases because the Government must show an element of intent.
– Mr. Osterweil indicates that while it is unlikely that a Belgian court would uphold criminal prosecution with respect to either formalistic or agressive tax planning short, apparently, of deception or misrepresentation on first impressions, he notes that "courts are more and more looking to the economic effect of a particular set of transactions and are not constrained by the literal interpretation of the law. See *Ines* case, Cour de Cassation, 7 December 1979."

3. Canada

– In Canada prosecutions for non-compliance are heard by the standard criminal courts and the Crown bears the burden of proof (see Appendix A, Question XI and Appendix F).
– Where covert non-compliance involves prosecutions under Sec. 239 by way of summary indictment, in Canada the Department of Justice can prosecute certain types of tax evasion either by what is known as "summary conviction", in which case the statute calls for either a fine or imprisonment at the option of the judge, or by way of indictment, in which case there is a mandatory sentence of imprisonment. It is rare indeed that the courts will impose a term of imprisonment in lieu of a monetary fine or penalty. See Gourlay, supra note 45 to text.
– In respect to tax avoidance (not non-compliance) the judicial response has not been consistent. After a period of vacillation, the Federal Court of Appeal in 1981 and 1982 made fairly clear that a business purpose was not requisite to a successful tax plan (*Atinco,* supra note 4 to text) although the doctrine of sham, substance over form or inadequate documentation or execution of tax planning arrangements may easily defeat the taxpayer, notwithstanding that he was not required to exhibit a business purpose in carrying out a transaction. Considering the matter of avoidance schemes within the context set out previously, one should be able to anticipate decisions which would not favor the taxpayer.
– Other experiences in Canada arising out of the factors outlined above respecting avoidance which may be of interest include:

* See Appendix B for Respondents.

- There has been substantial vacillation in Canadian courts as between "strict" and "liberal or contextual" interpretation, notwithstanding that the Supreme Court of Canada, which rarely hears tax cases these days, laid to rest the rule of strict interpretation as far back as 1956 and the Interpretation Act of Canada specifically ousts such approaches.
- Unlike the U.S., evidence of intent, comprising legislative history, etc., cannot be laid before a Canadian court (the case of *Reader's Digest Assn. of Canada* v. *Attorney General of Canada,* 61 DTC 1273).

4. Denmark

- Mr. Robert Koch-Nielsen reports that the Danish courts have no bias although "it is a general opinion among lawyers that criminal courts know very little about complicated tax law questions".
- Tax fraud is prosecuted in the standard courts and the Crown has the burden of proof as in other criminal cases.

5. France

- Few cases actually go to court, most being settled at the administrative level.[12] Where court procedures are involved, the following factors may be noted:
  - "Fraude" charges would be heard by the regular criminal courts.
  - It is not clear that the burden of proof would be on the Government in criminal tax prosecutions.
  - As a general matter, the courts do not show bias.

6. Germany (Fed. Rep.)

- Tax fraud prosecutions are heard before the criminal courts which alone are authorized to impose sanctions.
- As elsewhere, the burden of proof in criminal prosecutions is on the tax authorities.
- In line with the current trend in other countries, German courts are prone to considering the substance not the form of a transaction where aggressive tax avoidance schemes are involved. *"Ramsay* is in full line with German doctrine" (Rädler). Killius notes that "the intent and the spirit of the law is taken into account in construing the statutory language, at least where the intent or spirit has found an expression in the wording itself".

7. Hong Kong

- There are no separate tax courts to deal with non-compliance. "The courts are in the English tradition and have little bias in favour of either the Revenue or taxpayer."
- As in most countries the burden of proof in tax evasion prosecutions is on the Crown.
- Finally, it should be noted that "tax law is largely a matter of form rather than substance", presumably making it easier to utilize aggressive (but legal) tax planning and avoidance schemes.

8. Israel

- Dr. Rafael reports that "the courts are not biased against the taxpayer and he is afforded a fair and just trial". However, "the tax courts seem to have adopted a policy pursuant to which guilty offenders are punished severely. Indeed, in the last few years, quite a number of prison sentences have been imposed and the fines have been substantial. The courts have indicated that non-compliance with the fiscal laws of the country is a serious matter and cannot be dealt with lightly." In this context it should be noted that in Israel, Dr. Rafael reports, "only the courts are empowered to render sentences of imprisonment or the penalties prescribed for violations in Part XI of the Ordinance (Secs. 215 to 228(a)).
- The principle of *Ramsay*, supra note 6 (to the text), has been codified.
- In Israel tax fraud prosecutions are heard before the standard criminal courts and "the burden of proof lies with the authorities just as in any other criminal case", subject to certain exceptions such as under Sec. 223 of the Israeli Income Ordinance, dealing with offences under Sec. 217, where the taxpayer must rebut a presumption arising in favour of the Crown.

9. Italy

- Bruno Gangemi reports that "tax courts are required to be impartial".
- In Italy tax fraud is prosecuted before standard criminal courts and the burden of proof is on the prosecutor. As in most countries, the criminal courts do not deal with the civil matter, as well, the tax courts have competence to deal with administrative fines as opposed to penal sanctions.
- Interestingly, Mr. Gangemi reports, as an exception to the general trend noted elsewhere, "in dealing with highly aggressive or artificial tax plans, the courts apply the tax law literally", although there has been some contrary development recently.

10. Netherlands

- Tax prosecutions are heard in the (Lower) District Court (Penal Chamber) "and the burden of proof in straight fraud cases is on the Crown" (Van der Krabben).
- The Dutch courts do not show bias to either taxpayer or tax collector.
- As noted in Appendix C, "judges are becoming more aware of tax fraud and more cases are being prosecuted by the administration. It seems that the penalties are becoming heavier" (Korteland/Van Kempen).
- The burden of proof in non-fraud tax matters may be on the taxpayer or divided between the taxpayer and tax authorities; however, "in dealing with a charge in the prosecution for straight tax fraud normal penal code provisions are applicable. The burden of proof will be on the state prosecution to show beyond a reasonable doubt that the taxpayer has the intention to avoid tax . . . " (Van der Krabben).
- It was noted in the text and footnotes that Dutch courts have increasingly been rejecting (legal) tax avoidance schemes although not necessarily involving non-compliance. In this respect Korteland/Van Kempen note that "last summer and autumn the Supreme Court made some important decisions on the applicability of a special legal provision in the General Tax Act (Art. 31 GTA). According to this provision the Administration is allowed to disregard legal transactions if the result of such transactions is an avoidance of tax and it is clear that such transactions would not have been entered into without expected tax saving results and . . . in summary: in relation to highly aggressive or artificial tax plans the Administration has a tremendous weapon against tax evasion based on legal transactions without any economic reality." Mr. Van der Krabben adds that while "the tax courts apply the tax law literally if the relevant text is clear", in other cases (unclear law) "they will use the intent or spirit as a means of defeating approaches to tax avoidance". On the other hand, "in penal procedures there is normally no possibility than to apply the law literally".

11. New Zealand

- In New Zealand tax fraud is prosecuted before the standard criminal courts and the normal burden of proof, on the Crown, applies.
- New Zealand, like the U.K. prior to *Ramsay* and Australia prior to recent developments noted elsewhere generally sees "literal application of the tax law". (However, at the legislative level onerous anti-avoidance provisions dealing with aggressive planning, as opposed to non-compliance, have recently been introduced, resulting in assessment of taxes avoided through aggressive avoidance schemes, but without sanctions per se.)

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12. Supra note 4.

12. Norway

- In Norway, Mr. Jens-Jacob Sander reports, "the courts do not take a positive role in the issue in the form of bias in their decisions or in the manner in which discretions if any are utilized".
- As in most countries, in Norway tax fraud is prosecuted in the standard criminal courts and the burden of proof is on the Crown.

13. South Africa

- In South Africa "the tax courts do not take a particularly positive role in the issue". Mr. Jonathan Schwarz notes that in earlier years there was a "tendency on the part of the courts to rule in favour of the taxpayer although since 1975 this has no longer been the case". However, he points out that "decisions seem to be on a rather *ad hoc* basis and an inclination to decide for or against the taxpayer is not discernible".

14. Sweden

- In Sweden, Mr. Sten Hamberg reports, the "tax courts are indifferent – they assess tax. Tax penalties are automatic, they do not handle the criminal penalties."
- Prosecutions arise before the standard criminal courts although "a government proposal is expected within 6 months to end this and organize a special court for 'economic claims' to deal with both civil aspects and the criminal prosecution in one action".
- With respect to the burden of proof "in theory . . . (it rests) . . . with the prosecutor" although "few cases are expressly determined on this particular issue".

15. Switzerland

- Michael Kuhn reports that "tax courts do have the image of objectiveness, however, the tax administration is not afraid of going to court". He reports that "in the case of losing a case, the tax laws change fairly quickly".
- Richard Pease's reponse to the question of bias states that the courts are "generally fair".
- Tax fraud is prosecuted in the standard criminal courts, with the usual burden of proof.
- With respect to avoidance (rather than non-compliance), Swiss courts have followed the trend discussed above: supra note 46 to text.[13]

16. U.K.

- Criminal prosecutions would be heard by the standard criminal courts.
- John Avery Jones advises that there is little experience in this area in the U.K. Penalties can be mitigated by the Revenue and "the normal procedure is to negotiate the amount". As a result thereof, "very few cases of penalties ever reach the Commissioners or the courts and therefore I think one can say that they do not have much of a role in this area".
- As far as developments in the U.K. courts respecting artificial or tax avoidance schemes, see the decision in *Ramsay*, supra note 6 to text, which, as noted earlier, indicates a deviation from the traditional role of the U.K. courts of favouring the taxpayer by applying strict or literal interpretations of tax law.

13. With respect to avoidance, virtually all these countries (Italy excepted) generally reflect similar trends as *Ramsay* et al.: see note 47 to text.

APPENDIX F
REGINA VS. REDPATH INDUSTRIES ET AL., 83/DTC/5117
THE MEANING OF CRIMINAL SHAM[14]

Regina vs. *Redpath Industries Limited* and *Dominion Sugar Company Limited*, Court of Sessions of the Peace, Montreal, 14 December 1982, pages 31-51 of the Judgment dealt with sham in a criminal tax case; this is an excerpt of selected portions thereof.

I now must deal with the main "cheval de bataille" of the Crown, that is that the creation, maintenance and operation of Albion was a "sham" from beginning to end.

But, before entering into that domain, I would like to make the following points, which I believe are pertinent and germane to what is to follow.

It is neither deceitful nor illegal to set up what are sometimes called "puppet" or "dummy" companies that are without employees etc., so long as no deceitful or illegal means are used in so doing . . .

It does not necessarily follow that because the accused and the Bermuda corporations had "mutually supportive interlocking directorates" that this is necessarily illegal or even a sign of tax evasion. There is no law that prevents the existence of affiliated companies and it is taken for granted that they will work together for their mutual advantage . . .

To examine the case for the Crown more closely I believe we can state that the Crown contends that the creation and use of Albion was an artifice, a sham, a scheme willfully and fraudulently adopted by the accused to mask some of their profits and to present them as being profits of Albion, and that the said company was a mere pretense, fraudulently employed by the accused to reduce their taxable income in an illegal way . . .

In defence of its thesis, the crown cites the case of DOMINION BRIDGE COMPANY LTD. vs. THE QUEEN, (1975) C.T.C. 263, where Decary, J. stated at p. 269:

> The issue appears to me as one solely of fact: are the operations those of the appellant or of Span? Such an issue is not per se a fiscal one, but its consequences are . . .
>
> [Portion deleted]
>
> The means resorted to by the appellant for the operations of the business of Span and the manner in which Span was controlled and managed by the appellant preclude my being able to find that the business of Span was its own and not that of the appellant, I believe that the appellant has camouflaged, disguised the operations of Span to make them appear as independent of the appellant's whereas, in fact, the evidence, doumentary and oral, is pervaded with the control, management and presence of the appellant, its sole client . . .
>
> [Portion deleted]

He continues at page 270:

> The fact that the appellant always controlled every step of the operations of Span from the purchase price to the selling price of offshore steel, . . . was a sham and that its operations were also a sham . . .

However, the doctrine of sham is narrowed down, as we shall see, by the following cases . . . .

To begin with, there never was any question of fake or dubious ex-

14. See note 17 to the text (and related text).

penses or deductions in determining income. There was no contention that Albion did not really exist. . . . All these things were set forth clearly in the respective returns of the accused.

No evidence was ever adduced that the tax department was deceived . . .

From this leading case,[15] which has not been appealed to the Supreme Court of Canada, and which thereby remains a final judgment, it clearly emerges that the incorporation of a company to obtain a tax benefit in an offshore jurisdiction does not constitute a wrongful act under the Income Tax Law and does not even subject the parent company in Canada to taxation on the income of its offshore corporation. It is equally clear that there is no offence "per se" merely because the offshore subsidiary takes its instructions from elsewhere. Finally, it makes no difference that the parent company owns 100% of its offshore subsidiary, whereas in our case it was much less than that.

The Federal Court of Appeal also ruled that there was no sham if payments had been made pursuant to a written contract. That is precisely the case as between the accused and Albion . . .

From all of the direct and circumstantial proof that was led both by the Crown and the Defence, I consider the following facts as proven:

1. After obtaining legal and accounting advice from their attorneys and accountants, which advice was legal and ethical, the accused, with the sole intention of taking advantage of the provisions of Section 28, as it then was, of the Canadian Income Tax Act, set up a corporation in Bermuda called Albion;
2. Looking beyond appearances, it is clear that this Bermuda corporation was wholly controlled and managed by the accused;
3. By this, we mean that the actual operations of the Bermuda corporation were carried out through and by the accused and their parent company in London, England;
4. The accused and Albion did not deal with each other "at arm's length";
5. At no time did the accused hide or even attempt to hide this state of affairs from the fiscal authorities, but on the contrary, explicitly declared their relationship as between themselves and Albion to the effect that they were not dealing "at arm's length";
6. The accused fully disclosed all pertinent information to the fiscal authorities, as required by law;
7. The contracts between the accused and Albion were real and binding instruments that created contractual obligations between the parties, and both parties could sue and be sued by the other, on the basis of their contracts;
8. The Crown has not proven that any income tax other than that which was declared by the accused, is owed to the Department of Revenue;
9. The Crown has not proven any sham in this case;
10. Even if one were to consider that a sham existed in this case, no proof was led that it was a criminal sham;
11. No proof was made that the accused engaged in any tax evasion scheme and without limiting the foregoing, it must be stated that no proof was led that would show lies, deceit, falsehood, false documents and all the other usual means of unlawfully avoiding tax.

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15. Reference to *Spur Oil Limited* v. *The Queen,* 1981 CTC 336.

News from Latin America

Professor Ramón Valdés Costa
Honorary President of the Latin American Institute of Tax Law

During the XI *Jornadas Latinoamericanas de Derecho Tributario* (11th Latin American Tax Seminar) held at Rio de Janeiro 15 - 20 May 1983, Professor Ramón Valdés Costa was awarded the title of Honorary President of the *Instituto Latinoamericana de Derecho Tributario,* in recognition of his very important contributions to the study and development of tax law in Latin America. Professor Valdés, who is a member of the Advisory Council of the International Bureau of Fiscal Documentation and who received the Bureau's second silver medal for his work in furthering knowledge in the area of international tax law, was one of the founding members of the Latin American Institute, 15 years ago.

In his brief address of thanks, Professor Valdés paid tribute to the work of three Latin American colleagues, emphasizing the high level of Latin American doctrine in the discipline of tax law. The following is a brief résumé of Professor Valdés' words.

Professor Eduardo Riofrío Villagomez †

This outstanding scholar, author of numerous books on taxation, recently passed away. He was the founder and first president of the autonomous Fiscal Court of Ecuador and drafter of the laws instituting that country's Fiscal Code in 1959. As the highest judicial magistrate in fiscal matters he established a high level of jurisprudence, and as a university professor and author he was a convinced defender of the principle of territoriality in the field of international taxation.

Professor Carlos María Giuliani Fonrouge

Professor Valdés, in his address of thanks, paid tribute to this scholar from Argentina whose scientific activities extend over more than 50 years. Not only is Professor Giuliani Fonrouge the author of many treatises on tax law; he also prepared an excellent draft for the Argentine Fiscal Code in 1942 and was a co-author[1] of the Model Tax Code for Latin America published in 1967.

Professor Ernesto Flores Zavala

This year, Professor Flores Zavala will celebrate his 50th year of professional activity. He was the first president of the Latin American Institute of Tax Law and for many years the Dean of the Law School of Mexico. Among his many publications is the classic work "Finanzas Públicas Mexicanas" (Mexican Public Finance), now in its 24th edition. The participants in the seminar warmly applauded Professor Flores Zavala who was present among the many leading Latin American tax lawyers.

1. *Editor's note:* The other co-authors were the late Rubens Gomez de Sousa from Brazil and Professor Valdés himself.

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

To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. See also Erratum (p. 193 of the May 1983 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

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BLUMEREAU, Johan-Eric.
Aspects juridiques et fiscaux d'une implantation en Tunisie. Edition 1983.
Paris, Editions Eurafricaines [address see above], 1983. 172 pp.
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SEMINAR ON TAX POLICY AND research for Asian participants.
Manila, National Tax Research Center [First BF Condominium Building, Aduana Intramuros, Manila], 1982. 14 pp.
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Study describing business opportunities in Bangladesh with reference to political and economic background and outlook.
(B. 56.125)

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BUSINESS IN BIRMA.
Hong Kong, Business International Asia/Pacific Ltd. [address see above], 1983. 68 pp.
Study concerning doing business with Burma with reference to political and economic background and outlook.
(B. 56.146)

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BUSINESS PROFILE SERIES.
The People's Republic of China. Fifth Edition.
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Revised edition on China in the Business Profile Series providing general information on businesses, import, export and the economy.
(B. 56.126)

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INVESTING IN DEVELOPING countries.
OECD/DAC Member Countries' Policies and facilities with regard to foreign direct investment in developing countries.
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Paris, Organisation for Economic Cooperation and Development [2, rue André Pascal, 75775 Paris Cedex 16], 1982. 122 pp.
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Double tax treaties between developing and developed countries.
New Delhi, Milind Publications Private Ltd. [6E, Rani Jhansi Road, New Delhi 110055], 1983. 223 pp.
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World Bank Staff Working Papers No. 523.
Washington, The World Bank [1818 H Street, N.W. Washington DC 20433], 1982. 74 pp.
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World Bank Staff Working Papers No. 523.
Washington, The World Bank [address see above], 1982. 174 pp.
Second volume of series of working papers, relating to intergovernmental fiscal flows in India. This study examines the implications of revenue sharing for project finance.
(B. 56. 138)

CHELLIAH, Raja J.; SINHA, Narain.
State Finances in India. Volume 3.
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Washington, The World Bank [address see above], 1982. 76 pp.
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(B. 56.138)

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BUSINESS PROSPECTS IN MALAYSIA.
Coping with change in a new era.
Hong Kong, Business International Asia/Pacific Ltd. [address see above], 1983.
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Paris, Organisation for Economic Cooperation and Development [address see above], 1983. 63 pp.
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A guide to income-tax law.
Containing exhaustive notes with illustrations on provisions of the income tax ordinance, 1979, as amended up to 31-3-1981 and other useful information.
Eighth edition.
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MERCHANT, Akbar G.
Comments on the Finance Ordinance, 1982 and amendments in mercantile laws.
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London, BNA International Inc. [17 Dartmouth Street, London SW1H 9BL], 1982. 378 pp.
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(B. 104.562)

FORRY, John I.
A practical guide to foreign investment in the United States. Second edition.
Supplement of selected forms.
London, BNA International Inc. [address see above], 1982. 298 pp.
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Nathan Boidman:

The Foreign Affiliate System: Canadian Taxation After 1982

A Structured Overview

CCH Canadian Ltd., Toronto (1983)

Book review by Eric Osterweil

Studying a foreign tax system can be both rewarding and arduous. It can be rewarding because in comparing and contrasting another country's tax rules with those in one's own jurisdiction, the reader achieves a better perspective on the strengths and weaknesses of the two countries' respective taxing techniques. On the other hand, the task can be arduous because to comprehend fully any sophisticated tax system requires considerable time and effort absorbing tax concepts and methods which may be unfamiliar to him.

A study of Canada's taxation of foreign affiliates may be cited in support of these propositions but the element of difficulty can be largely diminished if there is available a good guide to lead us through the complex and occasionally arcane byways of Canada's taxation of income derived by Canadian companies from their holdings in foreign companies. Fortunately, Nathan Boidman's new book is precisely what is needed to render a complicated and difficult subject accessible and useful to tax practioners both Canadian and foreign.

Canada's system of taxation is based on the worldwide concept of taxation as distinguished from the territorial concept applied by many European and Latin American countries. As a result, income derived by a Canadian company from activities carried out through a foreign branch will be taxed in Canada subject to the application of a foreign tax credit. Dividends from foreign shareholdings are ordinarily not taxed until repatriated. Such dividends are grossed up by the underlying foreign taxes paid for the purpose of computing Canadian tax but the foreign taxes are available as a credit.

The problem is that this basic system can and apparently did lend itself to abuses on the part of Canadian taxpayers attempting to shelter foreign income through the use of entities located in low-tax jurisdictions. Taking a leaf from the U.S. Internal Revenue Code, in 1972 Canada adopted a system of rules referred to as the foreign affiliate system or the foreign accrued property income ("FAPI") system to prevent perceived abuses or loopholes in the Canadian Income Tax Act. Although the statute was subsequently amended on several occasions, the most significant changes were brought about by Bill C-139 which became law on 30 March 1983.

Mr. Boidman has undertaken the daunting task of setting forth concisely the basic tax principles involved and then explaining the changes which have been brought to prior law by the 1983 amendments. He does so in twelve chapters, most of which provide an overview of or introduction to the subject matter, a short summary of prior law and a detailed commentary of the new legislation with appropriate citations and cross-references.

The first four chapters are devoted to the basic attributes of the FAPI system. A brief chapter is devoted to the terms "foreign affiliate" and "controlled foreign affiliate" (CFA). In view of the fact that a CFA is required to include in its income for Canadian tax purposes its pro rata share of FAPI, considerable space is devoted to a determination of what elements make up FAPI. Not unexpectedly, there are many similarities between FAPI and subpart F income under U.S. tax law; but the differences are equally striking. Thus, FAPI generally includes dividends, interest, royalties and similar type of income and to that extent may be said to resemble the foreign personal holding company income component under subpart F. However, FAPI does not appear to include business profits including transactions with or on behalf of related entities except to the extent that such business profits are derived by companies located in a country with which Canada does not have an income tax treaty. In the U.S., on the other hand, this type of income may well be taxable pursuant to subpart F principles under the rubric of foreign base company sales income.

To determine whether income is "tainted" and thus deemed to be taxable in the hands of the Canadian parent, the foreign affiliate must maintain an exempt surplus account and a taxable surplus account. The relationship between the two types of accounts particularly where two or more CFAs file consolidated returns or benefit from group relief in the foreign jurisdiction is treated in some detail. It would appear that, as a general principle, a Canadian company receiving a dividend from a CFA where that dividend is derived from exempt surplus will be entitled to exclude that dividend from taxable income – shades of the participation privilege familiar to certain European jurisdictions?

Other thought-provoking chapters concern, inter alia, thorny questions pertaining to reorganizations of foreign affiliates, the disposition of foreign affiliates and affiliate financing and currency exchange issues.

Non-Canadian readers should be forewarned that this excellent book is not intended to be a comparative study of the Canadian system with other tax systems. Nor is it the author's intention to enter into a detailed economic justification for the FAPI system. With these "caveats" in mind, this book constitutes a useful and informative review of Canada's approach to a major set of international tax issues. Happily, the publishers have taken the trouble to furnish a very helpful topical index.

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Tax Changes in Jamaica: The 1983-84 Budget

By H.W.T. Pepper

Balancing a Budget in the inclement winds of a depressing economic climate is not the easiest of tasks, but Jamaica's Prime Minister and Minister of Finance and Planning, the Hon. Edward Seaga, P.C., M.P., is rather adept at getting things into line.

Partial conversion of specific duties on alcoholic drinks and cigarettes to ad valorem levies in last year's Budget has led to an automatic buoyancy in revenue yield when prices of those items rise.

Various, relatively painless, increases in taxes have been introduced in this year's Budget to add a further J$75 million to current revenue. These increases have, however, been tempered by tax reliefs for pensioners, first-time buyers of residences, and those producing handicrafts or working overtime.

Almost inevitably, one duty increase is on cigarettes (in some countries the fashion is to call it a "health tax"!) designed to produce J$24 million extra revenue.

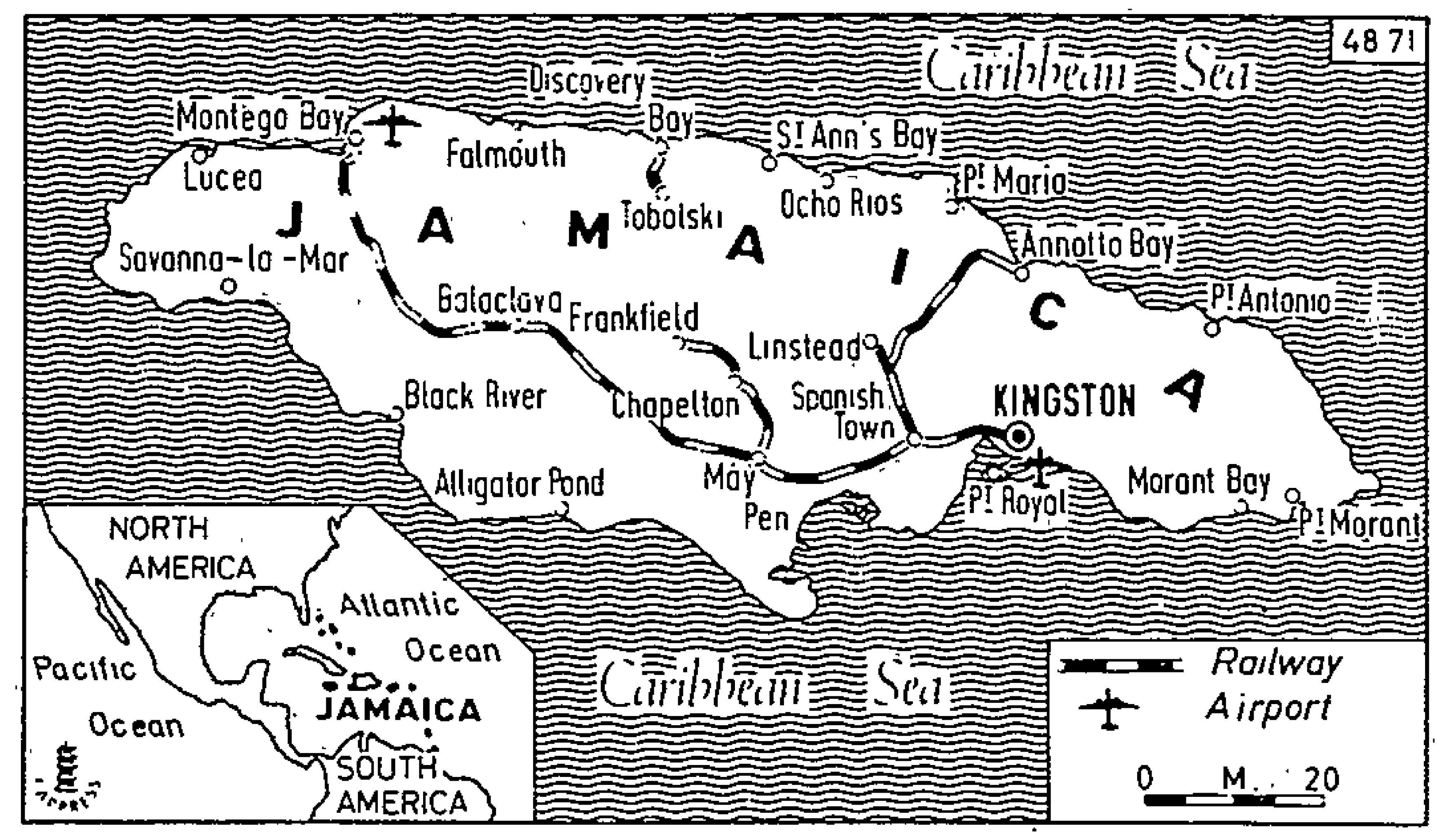
Motor vehicles (cars, trucks, and buses) – already, of course, taxed on first sale – are now to be taxed also on subsequent re-sales (up to the age of 8 years) at specific levies ranging from J$500 to J$1500 according to engine capacity.

Banks and financial institutions form one of the more prosperous sectors of the Jamaican economy and it has been decided to impose a levy to produce an additional J$8 million revenue from the life assurance section of the financial sector. Details of how to impose the levy will be discussed with the institutions themselves. Life assurance companies had already been favoured by generous reliefs to policy-holders in the form of tax relief on their premiums designed to encourage that form of saving.

A new levy, an "education tax" imposed at 0.5% on employees and employers on payroll (the self-employed are to pay 0.5% on their earnings, and domestic workers and their employers pay only 10 cents per week) should raise J$15 million to help finance improvements in education services, including the scheme, already under way, to try to ensure that all children really do attend school.

Amendments to the transfer tax on real property incorporate an updating of the basic exemption on purchase of a newly-built residence from J$4,000 to J$10,000), but also remove a potential avoidance factor by including in the value, for future tax assessment, "fixtures" embodied in the property. The changes are expected to produce a net increase in yield of J$6 million.

Finally, a system is to be introduced to assess self-employed taxpayers, who neither keep proper books nor make accurate tax returns, akin to the Forfait system in France and the Takshiv system in Israel. Bringing these taxpayers into the tax net is expected to produce J$10



million in additional revenue and will be termed the "M.A.P." (Modified Assessment Procedure) system.

In Jamaica, pensions in general have not been indexed and pensioners have, therefore, suffered much more than employees from the high inflation rates of recent years (reduced for the last two years to single figure inflation).

Pensioners were formerly given some extra personal relief from income tax. The present Budget now exempts the first J$10,000 of a pension from income tax.

Many workers have declined to work overtime, usually remunerated on a "time-and-a-half" basis, allegedly because of the higher tax rates payable when overtime pay lifts remuneration into higher tax brackets. An experimental relief is to be tried, provisionally for one year, by taxing overtime pay (to be precisely defined) at the flat basic rate of 30%.

Obviously the measure will create opportunities for tax avoidance, of which the Government is fully aware. For example, some professional and executive employees put in long hours without overtime pay and will no doubt be tempted to re-structure their remuneration into payment for basic hours, with extra pay for extra hours, provided their pension entitlements are not adversely affected. Nevertheless the proposed relief does provide an incentive to manual workers to work overtime when necessary.

Exemption from excise and consumption duties is to be given in respect of handicrafts made in Jamaica and to handicrafts made in CARICOM countries and imported.

This relief is intended to stimulate production of handicrafts and is also in keeping with exemptions afforded by various industrial countries in respect of hand-made handicrafts imported from Third World countries.

Most of the tax changes come into effect either immediately, or on 1 July 1983.

JAMAICA:

Budget 1983-84

Extracts from the Budget Speech pronounced on 5 May 1983 by the Right Hon. Edward Seaga, P.C., M.P., Prime Minister and Minister of Finance and Planning.

TAXATION MEASURES, 1983/1984

The taxation proposals presented to members of this Honourable House fall into three main groups, firstly, proposals for the raising of additional revenue of $75 million; secondly, measures designed to reduce the incidence of tax evasion and tax avoidance; and thirdly, measures for the relief of tax burdens on pensioners and in respect of 'overtime work' and the manufacture of handicraft goods.

. . .

Additional consumption duty on cigarettes

Prior to 26th March, 1982 the revenue from cigarettes was derived by way of a specific duty of $6.5970 per 100 cigarettes. Thereafter, 50% of the specific duty was converted to an ad valorem duty, so that on 26th March, 1982 the consumption duty structure was as follows:

Specific duty . . .	$3.2985 per 100 cigarettes
Ad valorem duty	32.985%

It is now proposed to increase the consumption duty by 41 cents per pack of 20 cigarettes.

The additional revenue expected to accrue from this source is $24 million for the financial year 1983/84. It is anticipated that after the increase in duty the retail price of a pack of 20 cigarettes will rise to $3.10.

. . .

Special levy on earnings of life insurance companies

This proposal is a further step in the development of a tax regime for life insurance companies and is designed to ensure that the tax contribution of the life insurance industry is appropriate to its relative taxable capacity.

At present, a life insurance company is liable–

(i) to income tax at the rate of 37½% on the amount of its investment income *less* management expenses; and

(ii) to a further income tax at the rate of ½% on its net premium income (the rate is 2% in the case of a company which is not Jamaicanized).

The computation of tax liability based on the formula – investment income *less* management expenses, invariably yields a "loss", the effect of which is that the majority of life insurance companies suffer no income tax on investment income.

As early as 1970 the Government recognized the difficulty of assessing the earnings of a life insurance company and took an initial step by introducing a minimal ½% tax on net premium income. In recent years the tax contribution of the life insurance industry as a whole based on the existing system of taxation has not exceeded $2m in any year. Recent investigations suggest that life insurance companies are capable of making a more significant tax contribution particularly at this time when the need for additional revenue is urgent.

The additional revenue which the life insurance companies could reasonably contribute is estimated at $8m per annum.

Accordingly, it is proposed to introduce a new tax regime for life insurance companies. Instead of the existing tax provisions in the Income Tax Act, a life insurance company will be liable to a special levy. In this regard, the Government is aware of the special nature of the life insurance business and in particular the considerations involving the provision of reserves against future liabilities. For these reasons, the opportunity will be taken to discuss with representatives of the life insurance industry the application of the proposed special levy.

Retail sales tax on "second sales" of motor vehicles

A retail sales tax is to be imposed on the transfer ("second sales") of motor cars, trucks and buses in accordance with the following scale:

C.C. rating	*Retail sales tax*
	$
Less than 2,000 c.c.	500
Exceeding 2,000 c.c., not exceeding 3,000 c.c.	1,000
Exceeding 3,000 c.c.	1,500

Every purchaser of a motor car, truck or bus within 8 years of the manufacture of the vehicle will be required at the time of the transfer of the vehicle to pay retail sales tax to the Collector of Taxes.

For the purposes of the tax "transfer" means–

(i) any transfer of title or possession, exchange barter, lease or rental conditional or otherwise or any legal or equitable transfer by way of sale including a sale on credit or where the price is payable by instalments, or any other contract (whether or not a hire-purchase contract) whereby at a price or other consideration a person delivers to another person tangible personal property, gift, grant, assignment, surrender, release or other disposal;

(ii) any transfer by or at the order or direction of a court of competent jurisdiction.

Under the existing provisions of the Retail Sales Tax Act, the vendor of prescribed goods is treated as an agent of the Collector General and as such is required to levy and collect the taxes imposed under the provisions of the Act. However, under the provisions of the proposed retail sales tax it is the purchaser or transferee or the person who acquires the chargeable motor vehicle and not the vendor or transferor who will be held liable to pay the retail sales tax to the Collector of Taxes. Accordingly, the Collector of Taxes will be empowered to collect any retail sales tax due and payable by the purchaser or transferee at the date of the transfer of the chargeable motor vehicle, or in relation to the lease of the chargeable motor vehicle, as the case may be.

In order to effect the transfer of a chargeable motor vehicle, the transferee must attend at the office of the Collector of Taxes and make a statutory declaration of the particulars of the transfer and the c.c. rating of the motor vehicle. The declaration must be accompanied by a copy of the bill of sale or invoice or any other document showing the nature of the transaction. The declaration will record–

(a) the name of the purchaser or transferee of the motor vehicle;

(b) the name of the seller or transferor of the motor vehicle;

(c) the description of the motor vehicle.

In the case of motor vehicles transferred in circumstances which would upon first importation have rendered them exempt from customs duty, no tax will be imposed; for example, where a motor vehicle is imported free of duty by a person entitled to diplomatic privileges and is subsequently sold or transferred to another person who is also entitled to customs duty privileges.

The retail sales tax will apply in respect of any chargeable motor vehicle transferred on or after 6 May 1983.

The anticipated revenue yield from the foregoing proposal is $12 million for the financial year 1983/84.

Transfer tax adjustment

Under the Transfer Tax Act, tax is charged at the rate of 5% of the amount of the consideration for each transfer of "property" or 25% of the capital gains accruing on the disposal of the "property", whichever is less. For purposes of the Act "property" includes "land", which, by definition "includes land of any tenure and tenements and hereditaments, corporeal or incorporeal, messuages, houses, buildings and other constructions. . . ."

The practice has developed among vendors and transferors of property of reducing the amount of consideration by deducting therefrom sums purported to represent the value of fixtures and furniture which form part of the "property" transferred.

The Act is therefore to be amended –

(i) to provide that –

  (a) "land" includes "fixtures", and, as the case requires, shall be extended to include "furniture" in a case where "furniture" is part of the transaction of sale; and

  (b) notwithstanding anything to the contrary, the Stamp Commissioner shall be entitled to compute and charge transfer tax on the price which in his opinion the subject property might reasonably be expected to fetch on a sale in the open market;

(ii) to further relieve the tax burden on "first sales" (e.g. sales by developers of new houses in a housing scheme) by increasing the amount of the consideration which is exempt from tax from $4,000 to $10,000;

(iii) to withdraw the exemption provision (i.e. $4,000) in respect of sales other than "first sales" in order to capture some increment of tax from speculative activities.

Modified assessment procedures system (MAP system)

Considerable difficulty is being encountered in assessing the appropriate tax of self-employed persons. As is well known most of these income earners do not keep any proper accounts which could form the basis of preparing their tax returns and attempts to force them to fulfill the requirements of the law in this respect have not been successful. Consequently, these groups contribute very little to the revenue and such a situation cannot be allowed to continue unchecked.

These considerations necessitate the use of more effective administrative techniques for dealing with the problem of evasion. One such technique is to tax presumed rather than actual income. The use of presumptive techniques for tax assessment when normal procedures cannot be followed for special reasons is not something new or unique. Undoubtedly, the best known and most developed system of taxing estimated income is that developed in Israel, referred to as the "takshiv". The presumptive technique is also being extensively used in the tax systems of some advanced countries such as France (the forfait regime), Sweden and Japan, as well as developing countries such as Korea and recently Bolivia where a similar system was introduced by the Musgrave Mission.

In order to reduce the level of tax evasion by these groups of delinquent taxpayers and consequently to increase our revenue flows, it is proposed to introduce during the course of this year a system of assessment based on new estimation techniques.

The essence of the proposed method of assessment is the establishment of a set of standard assessment guidelines for each major economic activity, on the basis of which the income for any individual taxpayer can be estimated in a relatively objective fashion. Guidelines will be developed for various activities and updated from time to time.

The system will be introduced selectively and in the early stages will be concentrated in those areas where there is significant revenue potential and for which reasonable quantitative information on indicators is available. The standard assessment guidelines will apply, unless the taxpayer can show that his actual liability is less than that calculated under the proposed system. He will be able to do this only if he complies with the ordinary income tax requirements of keeping detailed records and accounts and furnishes income tax returns in the usual way. Under the proposed system taxpayers will not be permitted to claim losses and other reliefs. The entitlement to such losses and reliefs will be confined to persons who have filed detailed income tax returns in the usual way supported by verifiable records maintained in the manner required by law. This provision is important in order to provide some incentive for taxpayers to move from the estimated tax system into the regular tax system. A further incentive to move from the MAP System will be a provision whereby if on the production of proper income tax returns the taxpayer becomes entitled to a refund, the amount refundable will include interest at the Treasury Bill rate of interest in force at the time of payment of the refund.

Education tax

This proposal represents a special effort on the part of Government to initiate meaningful change in the level of expenditure on the development of human resources through the formal education processes. At this stage, particular attention is being focussed on the need to deal with long neglected problems in the field of education. To achieve this objective a special tax raising measure to be known as the education tax will be introduced.

The education tax will be charged on the same base as that on which contributions under the National Housing Trust Act are charged, namely, the emoluments of an employed person, or earnings in the case of a self-employed person. The education tax will be payable by employed persons, employers and self-employed persons as follows–

Taxpayer	*Rate of tax*
1. Employed persons:	
(i) An employed person over the age of 18 years and under retirement age employed as a domestic helper	10 cents a week
(ii) A citizen of Jamaica over the age of 18 years and under retirement age employed by Embassies, High Commissions, Consulates or United Nations Agencies situated in Jamaica	½% of this emoluments
(iii) A person who is not a citizen of Jamaica over the age of 18 years and under retirement age resident in Jamaica and employed therein other than to Embassies, High Commissions, Consulates or United Nations Agencies	½% of his emoluments
(iv) Any employed person over the age of 18 years and under retirement age other than those specified at sub-paragraphs (i), (ii) and (iii)	½% of his emoluments
(v) A citizen of Jamaica over the age of 18 years and under retirement age employed by a Jamaican Embassy, Jamaican High Commission, Jamaican Consulate or a Jamaican company, resident abroad	½% of his emoluments
Employer:	
In respect of the category of persons specified at paragraph 1(i)	10 cents a week
In respect of the category of persons specified at paragraphs 1 (ii), (iii), (iv) and and (v)	½% of the emoluments of the persons specified
2. Self-employed persons:	
(i) earnings in any week less than the minimum wage	nil
(ii) other than those specified under sub-paragraph (i)	½% of his earnings

The education tax will be charged with effect from 1 July 1983, so that employers and self-employed persons will be required to make a first payment of education tax to the Collector of Taxes on or before 14 August 1983 in respect of emoluments for the month of July, 1983.

The education tax is estimated to yield $15 million during the financial year 1983/84.

Income tax reliefs in respect of pensioners and "overtime work"

In recent times two groups of taxpayers have consistently claimed that the rates of personal income tax have had a deleterious effect on the levels of their disposable incomes. These groups are individuals receiving wages for "overtime work" and retired individuals whose only source of income is a pension.

"Overtime work"

In this case it is proposed to grant relief in respect of wages received for "overtime work" by applying the lowest marginal rate of tax, that is, 30% to the amount of wages attributable to "overtime work". For this purpose "overtime work" and "normal working day" will be defined along the following lines:–

"Overtime work" means any work done during any period –

(a) on a rest day; or
(b) on a public holiday; or
(c) in excess of 8 hours on a normal working day; or
(d) in excess of 40 hours in any week; or
(e) in excess of 5 normal working days in any week; or
(f) on a Sunday; or
(g) in excess of single time work week established by arbitration award or contract which contract existed prior to 5 May 1983.

The tax relief will be introduced initially for a period of one year, commencing on Labour Day, 23 May 1983, and thereafter will be reviewed against the background of the performance of workers and employers in order to determine the feasibility of continuing the relief measure.

The proposed scheme will be embodied in regulations which will be strictly enforced.

Pensioners

The available records reveal that there are 10,017 pensioners in the Island, 7,135 of whom are Government pensioners and the remainder of 2,882 are from the Private Sector. In general, the level of pension payments is low throughout the Public and Private Sectors and a preliminary study shows that not more than 102 individuals receive pension payments in excess of $10,000 per year.

It is therefore proposed to exempt from income tax with effect from the year of assessment 1983, the first $10,000 of the pension of any individual who is a Government pensioner or who receives a pension from an Approved Superannuation Scheme.

Consumption duty and excise duty relief in respect of handicraft goods

Under this proposal, handicraft goods will be exempted from consumption duties, excise duties and the corresponding Caricom customs duties which extend excise duties to imported goods of Caricom origin. Customs duty exemption will not, however, be applicable to handicraft goods imported from third countries as such a measure would require the sanction of the Caricom Council of Ministers and in any event would not be desirable.

. . .

Liability of directors and officers of bodies corporate in relation to P.A.Y.E. tax withheld and statutory contributions

There has been a marked neglect by corporate bodies in relation to the payment of P.A.Y.E. tax withheld and statutory contributions. Investigations suggest that this incidence of non-compliance may be attributed in part to the neglect by directors of bodies corporate in carrying out their fiduciary duties in accordance with the constitution of the bodies they represent. This phenomenon is especially marked in the case of directors of Government companies and the executives of Statutory Bodies.

The purpose of this Paper is to outline the additional measures which will be taken to strengthen the existing legislation in order to ensure an improved level of compliance.

Income tax

As members are aware, the directors of a body corporate are pursuant to Section 41 of the Income Tax Act jointly and severally liable together with the body corporate and are guilty of an offence where income tax has not been deducted and also where it has been deducted and not paid over to the Commissioner. If the tax were deducted and not paid over to the Commissioner the tax will be treated as increased at the rate of 50% per annum in respect of each day that the failure continues. If the tax were not deducted it will be treated as if the tax were increased at such rate not exceeding 50% as the Commissioner may direct. Directors will, however, not be liable if they prove that they satisfied themselves that the body corporate had established an adequate system providing for all tax so deducted by it to be paid or accounted for by the required date and that the failure to operate that system occurred without their consent or connivance and without any negligence on their part.

National Insurance Act

The National Insurance Act states that every person over 18 years and under retirement age domiciled or resident and gainfully occupied in Jamaica shall become insured under the Act. Employers are liable to deduct and pay over contributions and an employer is entitled to recover from an insured person the amount of any contribution paid by him on behalf of that person. If any insured person or employer fails to pay at or within the time prescribed any contribution which he is liable to pay he shall, for each offence, be liable on summary conviction to a fine in the Resident Magistrate's Court. Where an offence under the National Insurance Act has been committed by a body corporate and it is proved to have been committed with the consent or connivance of, or to be attributable to any negligence on the part of any director, manager, secretary or other officer of the body corporate, he as well as the body corporate shall be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly (Section 44(10)). All sums of money owed to the National Insurance Fund bear interest at the rate of 20% per annum and may be recovered without limit of amount as a civil debt. The National Insurance Collection of Contributions Regulations 1966 states, inter alia, that within 14 days after the end of every month the employer must pay to the Collector of Taxes all amounts deducted by him. Failure to do this will be an offence and will attract the penalties set out in the Act.

Directors of companies can therefore be held personally liable for the payment and even more so the failure to pay over statutory contributions owed to he National Insurance Fund.

National Housing Trust Act

The National Housing Trust Act also imposes an obligation on the employer to deduct and pay over National Housing Trust contributions.

If the employer is a body corporate and fails to pay to the National Housing Trust any sum which the employer has been ordered to pay that sum or the part which remains unpaid is a debt due to the Trust jointly or severally from any director of the body corporate who knew or could reasonably be expected to have known of the failure to pay the contributions in question (Section 37(5)). If the offence under the National Housing Trust Act has been committed by a body corporate and is proved to have been committed with the consent or connivance of or to be attributable to the negligence on the part of any director, manager, secretary or other officer of the body corporate, he as well as the body corporate shall be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

Human Employment and Resource Training Act

The provisions of the Human Employment and Resource Training Act concerning compliance are similar to those of the National Insurance Act and state in effect that directors of companies can be held personally liable for payment or the failure to pay Human Employment and Resource Training contributions.

The provisions of the Income Tax, National Housing Trust, National Insurance and Human Employment and Resource Training Acts make it clear that directors of companies can be held personally liable for failure to deduct and pay over income tax and statutory contributions. However, there is wide variation in the levels of penalties for similar offences committed under the various Acts. For example, under the National Insurance Act the penalty for each offence of non-compliance is a fine not exceeding $50 and in default of payment of the fine, imprisonment for a period not exceeding 3 months, while under the recently enacted Human Employment and Resource Training Act the fine for the same offence would be $5,000 and in default of payment of the fine, imprisonment for a period not exceeding 12 months.

It is therefore proposed–

(i) to standardize the penalties under the Income Tax, National Housing Trust, National Insurance and the Human Employment and Resource Training Acts;

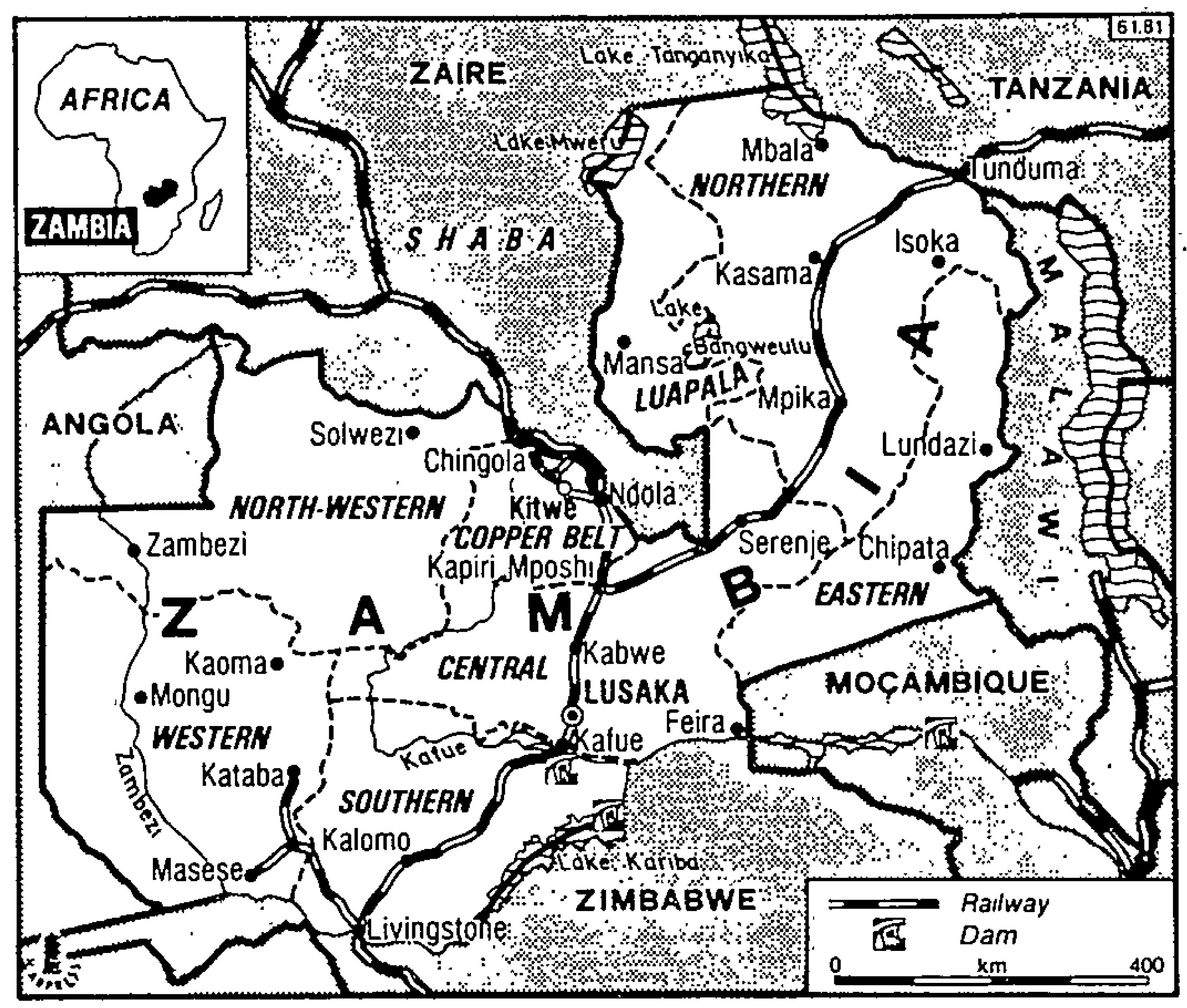
(ii) to strengthen the existing provisions in the Income Tax, National Housing Trust, National Insurance and the Human Employment and Resource Training Acts along the lines of Section 122 of the Excise Duty Act which reads as follows: – "Where the person responsible for any act or omission under this Act is a body corporate every person who at the time of that act or omission was a director or officer of the body corporate, shall be liable for all [excise] duties arising therefrom and any penalty in relation thereto unless he proves that the act or omission occurred without his knowledge or that he exercised all due diligence to prevent the occurrence thereof".

(iii) to provide in the Income Tax, the National Housing Trust, the National Insurance and the Human Employment and Resource Training Acts that in relation to statutory bodies the liability for compliance with the provisions governing the deduction and payment of P.A.Y.E. tax and statutory contributions will rest on the officer designated by the organisation concerned as the "responsible officer" – (liability for compliance will not rest on the "responsible officer" in relation to tax and statutory contributions which fell due prior to his designation).

The provision at sub-paragraph (iii) will not apply to bodies corporate registered under the Companies Act.

Zambia's 1983 Budget

by A.B.C. Emmanuel



The 1983 Budget was termed a realistic but a tough budget. "The nation is going through an economic crisis and only if each and every one of us works diligently shall we overcome this crisis. These are hard times which require drastic measures whose burden must be shared by all Zambians", said the Finance Minister when he introduced the Budget. Zambia, which depends heavily on copper for its revenue, saw the price of copper decline sharply in real terms when it reached its lowest in 40 years in June 1982. The market price dropped to £684 or K 1,120 per tonne. Copper earnings dropped from K 884 million in 1981 to K 840 million in 1982 and now to K 814 million in 1983. This represented a decrease of 3.1%. However, there has been a slight increase in the world price of copper which gives a ray of hope for the future. The drop in the world price of copper has had a very adverse effect on the country's foreign exchange earnings and on the mining industry.

Added to this dismal situation was the severe drought that has prevailed in the last two seasons which forced the country to import large quantities of maize to feed the nation. The drought resulted in a decline in production of 19% as compared to an increase of 27% in 1981. Maize purchased by the marketing agencies fell from 7.7 million bags in 1981 to 5.6 million bags in 1982 despite an increase of 16% in the hectarage planted over the 1980/81 season.

The good work done by the farmers in 1981 was undone by the severe drought which left them in financial difficulties. In short, the performance of the agricultural sector was unsatisfactory due to persistent adverse weather conditions.

The manufacturing sector recorded a slight improvement but not sufficient to meet the growing unemployment among the youth. This sector unfortunately still depends on foreign imports for its needs. Zambia spends 80% of its export earnings on imports, and this sector uses about 35% of the country's total imports. Not much progress has been made to utilise local raw resources as inputs in most manufacturing enterprises. The Hon. Minister promised to revise the Industrial Development Act so as to promote the use of local resources. The Government would also encourage small industries mainly in the rural areas especially those that are agro-based which will not only provide employment in rural areas but also slow down the drift of people to urban areas. Financial institutions have been called upon to give generous aid for such projects.

The Government, which is involved in the manufacturing sector through parastatal organisations, will now encourage investments which have a strong bias towards import substitution or export orientation. The ZIMCO group of companies have been requested to streamline their management structure and improve their efficiency so as to operate on sound commercial lines and pursue the policy of the Government and achieve their goals and not depend on Government help for their existence as has been done in the past.

The balance of payments position, instead of showing any improvement, continued to deteriorate in 1982. The principal cause was the increase in the nation's foreign debt service payments. In addition, imports valued on a f.o.b. basis rose from K 911 million in 1981 to K 951 million in 1982. The value of exports rose from K 927 million in 1981 to K 971 million in 1982. A substantial proportion of the overall balance of payments deficit was accounted for by a further accumulation in the external payment arrears. At the end of 1981 these arrears were about K 430 million and by December 1982 they had risen to K 680 million. To have good trade relationships and progressive annual improvements in the balance of payments situation it is necessary to have an orderly and planned repayment of these debts based on a rescheduled timetable.

With a view to improving the balance of payments position, the Government, after much deliberation, decided to devalue the kwacha by 20%. Although this was not a popular move, the Government had no alternative. The steady fall in foreign exchange earnings had in fact brought about a de facto devaluation of the kwacha despite the fact that the kwacha had been artificially maintained at a parity above its real value. There were many factors which forced the Government to devalue the kwacha: one was the fact that some of the neighbouring countries with similar economic difficulties did devalue their currencies. To be competitive in the world market, especially where the commodities are similar to those exported by neighbouring countries, Zambia had to offer comparable prices. The other factor was that the mining industries could by this devaluation make gains on the exchange of hard currencies in terms of kwacha. This will make mining operations less unprofitable and thereby improve the mining company's cash flow position. The Government has invested heavily in the mines and it was very interested to see that the losses are reduced considerably and also that it does get a return for its investment.

Mr. Emmanuel is the tax manager of Price Waterhouse & Co., Lusaka, Zambia.

TAX MEASURES

Although the prices of beer, cigarettes, sugar, spirits, petrol, diesel and paraffin did go up, there was no increase in income tax for either corporations or individuals. The Hon. Minister of Finance preferred indirect as against direct taxation. He realised that the burden on the taxpayer by the rising cost of living left little in the taxpayer's pocket. He thus decided to widen the scope of the sales tax by including many locally produced commodities which had hitherto been exempted. At present the rates of sales tax vary from 5 to 50%. These rates were increased from 15 to 50%. This revision of rates was to bring in additional revenue of about K 5 million.

Excise duties were raised on beer, cigarettes, spirits, mineral waters, sugar and petroleum products. These were to bring in additional revenue of about K 85 million.

Adjustments were made to the existing customs tariff and these were to bring in about K 11.5 million.

A new tax, called the mineral export tax, was introduced. Due to losses, the mines have made no contribution to the revenue of the country. In view of the fact that the Government has invested heavily in the mines, the Government decided to levy an export tax on all minerals exported. The rate has been fixed at 4% of the export value and it is expected to realise K 45 million.

There was a proposal to introduce a road toll chargeable on all vehicles using the roads, but this has not yet been implemented. There was also a proposal to increase stamp duty and other fees on licences, fines, etc. These too have not yet been implemented.

CONCLUSION

The economic prospects for 1983 do not appear to be very bright. Zambia depends heavily on copper for its revenue and for its foreign exchange earnings. The demand for it is mainly from industrial countries whose economies have been affected by recession, and there is not much hope that there would be an increase in demand in the oncoming year. The only hope is the diversification of the economy and the shifting of importance from copper to agriculture. This too has had a very bad year due to the continued drought in this region of Southern Africa, which requires a change in the methods of cultivation, i.e. a switch to irrigation methods and also to drought-resistant crops. Zambia has enough land which is quite fertile and unless this richly endowed resource is carefully and efficiently utilised it would mean an uphill task for the country. "All sections of the economy must contribute to the welfare, production of income and investments in the country. High consumption levels completely unrelated to increases in production can only spell doom", said the Hon. Minister of Finance.

The whole nation has to concentrate its efforts therefore on increased productivity for its survival.

CANADA: INTERPRETATION OF TAX TREATIES

On 23 June 1983 the Hon. Paul Cosgrove, Minister of State (Finance), tabled a Ways and Means Motion relating to the interpretation of Canada's tax treaties with other countries.

The proposed legislation, referred to as the Income Tax Conventions Interpretation Act, is in response to a decision of the Supreme Court of Canada. The Court held that the meaning of words and expressions in Canada's tax treaties is to be determined at the time the treaty is adopted.

"The Supreme Court decision effectively freezes the meaning of terms in a way that was not intended when the treaty negotiations took place", Mr. Cosgrove said. "This proposed legislation provides for the meaning of treaty terms to generally evolve with changes to the Canadian tax law".

A detailed technical explanation of the provisions of the proposed legislation and a copy of the Ways and Means Motion are attached.

Notice of Ways of Means Motion with respect to the interpretation of Canada's international conventions relating to income tax and the Acts of implementing such conventions

That it is expedient to introduce a measure with respect to the interpretation of Canada's international tax conventions reading as follows:

SHORT TITLE

1. This Act may be cited as the *Income Tax Conventions Interpretation Act.*

DEFINITION

Definition of "convention"

2. In this Act, "convention" means any convention or agreement between Canada and another state relating to tax on income, and includes any protocol or supplementary convention or agreement relating thereto.

INTERPRETATION

Meaning of undefined terms

3. Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is and always has been that to the extent that a term in the convention is:
(a) not defined in the convention,
(b) not fully defined in the convention, or
(c) expressed to be defined by reference to the laws of Canada,

that term has the meaning it has for the purposes of the *Income Tax Act,* as amended from time to time, and not the meaning it had for the purposes of the *Income Tax Act* on the date the convention was entered into or given the force of law in Canada if, after that date, its meaning for the purposes of the *Income Tax Act* has changed.

Permanent establishments in Canada

4. Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is and always has been that where, for the purposes of the application of the convention,

Avis de motion de voies et moyens concernant l'interprétation des conventions internationales conclues par le Canada en matière d'impôts sur le revenu et de leurs lois de mise en oeuvre

Qu'il y a lieu de présenter un projet de loi concernant l'interprétation des conventions fiscales internationales conclues par le Canada de la teneur suivante:

TITRE ABREGE

1. *Loi sur l'interprétation des conventions en matière d'impôts sur le revenu.*

DEFINITION

Définition de "convention"

2. Pour l'application de la présente loi, "convention" s'entend de toute convention ou de tout accord conclus entre le Canada et un autre Etat en matière d'impôts sur le revenu, y compris tout protocole, out toute convention ou tout accord complémentaires y afférents.

INTERPRETATION

Sens d'expressions non définies ou autres

3. Par dérogation a toute convention ou à la loi lui donnant effet au Canada, le droit au Canada est et a toujours été tel que les expressions appartenant aux catégories ci-dessous s'entendent au sens qu'elles ont pour l'application de la *Loi de l'impôt sur le revenu* compte tenu de ses modifications, et non au sens qu'elles avaient pour cette application à la date de la conclusion de la convention ou de sa prise d'effet au Canada si, depuis lors, leur sens pour la même application a changé. Les catégories en question sont:
(a) les expressions non définies dans la convention;
(b) les expressions non définies exhaustivement dans la convention;
(c) les expressions à définir d'après les lois du Canada.

Etablissements stables au Canada

4. Par dérogation à toute convention ou à la loi lui donnant effet au Canada, le droit au Canada est et a toujours été tel que, dans le cas où, pour l'application de la convention, les bénéfices provenant d'une activité d'entreprise, y compris une

the profits from a business activity, including an industrial or commercial activity, attributable or allocable to a permanent establishment in Canada are to be determined for any period,
(a) there shall, except where the convention expressly otherwise provides, be included in the determination of those profits all amounts with respect to that activity that would be required to be included under the *Income Tax Act,* as amended from time to time, by a person resident in Canada carrying on the activity in Canada in the computation of his income from a business for that period; and
(b) there shall not be deducted in the determination of those profits any amount with respect to that activity that would not be deductible under the *Income Tax Act,* as amended from time to time, by a person resident in Canada carrying on the activity in Canada in the computation of his income from a business for that period.

Meaning of certain terms

5. Notwithstanding the provisions of a convention of the Act giving the convention the force of law in Canada, in this section and in the convention,
(a) the term "Canada" is hereby declared to include, and to have always included,
   (i) the sea bed and subsoil of the submarine areas adjacent to the coasts of Canada in respect of which the Government of Canada or of a province grants a right, licence or privilege to explore for, drill for or take any minerals, petroleum, natural gas or any related hydrocarbons, and
   (ii) the seas and airspace above the submarine areas referred to in subparagraph (i) in respect of any activities carried on in connection with the exploration for or exploitation of the minerals, petroleum, natural gas or hydrocarbons referred to in that subparagraph; and
(b) the terms "immovable property" and "real property" with respect to such property" in Canada are hereby declared to include, and to have always included,
   (i) any right to explore for or exploit mineral deposits and sources in Canada and other natural resources in Canada, and
   (ii) any right to an amount computed by reference to the production from, or to the value of production from, mineral deposits and sources in Canada and other natural resources in Canada.

Meaning of "interest"

6. Notwithstanding section 3, the meaning of the term "interest" in any convention given the force of law in Canada before November 19, 1974 does not include any amount paid or credited, pursuant to an agreement in writing entered into before June 23, 1983, as consideration for a guarantee referred to in paragraph 214(15)(a) of the *Income Tax Act.*

activité industrielle ou commerciale, imputables à un établissement stable au Canada, doivent être calculés pour une période donnée, les dispositions suivantes sont à observer:
(a) sont inclus dans le calcul de ces bénéfices, sauf disposition contraire de la convention, tous les montants afférents à cette activité qu'une personne résidant au Canada et y exerçant cette activité est tenue d'inclure, aux termes de la *Loi de l'impôt sur le revenu* compte tenu de ses modifications, dans ses revenus d'entreprise pendant cette période;
(b) ne sont pas déduits, dans le calcul de ces bénéfices, les montants afférents à cette activité qu'une personne résidant au Canada et y exerçant cette activité ne peut déduire, aux termes de la *Loi de l'impôt sur le revenu* compte tenu de ses modifications, dans le calcul de ses revenus d'entreprise pendant cette période.

Sens de certaines expressions

5. Par dérogation à toute convention ou à la loi lui donnant effet au Canada, les définitions qui suivent s'appliquent au présent article et à la convention.
(a) Le Canada comprend et a toujours compris:
   (i) le fond et le sous-sol de la mer dans les régions sous-marines adjacentes aux côtes du Canada relativement auxquels le gouvernement du Canada ou d'une province accorde un droit, une licence ou un privilège portant sur l'exploration ou le forage pour la découverte de minéraux, du pétrole, de gaz naturel ou de tout hydrocarbure apparenté, ou visant leur extraction,
   (ii) les mers et l'espace aérien au dessus des régions sous-marines visées au sous-alinéa (i), à l'égard de toute activité poursuivie en rapport avec l'exploration pour la découverte de minéraux, du pétrole, de gaz naturel ou des hydrocarbures, visés à ce sous-alinéa ou leur exploitation;
(b) les expressions "biens immobiliers" et "biens immeubles" dans le cas où ces biens sont situés au Canada, s'appliquent et se sont toujours appliquées:
   (i) au droit d'exploiter les gisements minéraux, sources et autres ressources naturelles au Canada et au droit de faire de l'exploration relativement à ceux-ci,
   (ii) au droit à un montant calculé sur la base de la production ou de la valeur de la production des gisements minéraux, sources et autres ressources naturelles au Canada.

Sens d'intèrêts

6. Par dérogation à l'article 3, le terme "intèrêts", dans les conventions qui ont eu 25 effet au Canada avant le 19 novembre 1974, ne s'applique pas aux montants versés ou crédités en vertu d'un accord écrit conclu avant le 23 juin 1983 en contrepartie d'une garantie visée à l'alinéa 214(15)(a) de la *Loi de l'impôt sur le revenu.*

TECHNICAL EXPLANATION PROPOSED INCOME TAX CONVENTIONS INTERPRETATION ACT

This Bill will introduce legislation containing rules for use in interpreting Canada's double taxation agreements and conventions. The provisions in the Bill will be generally consistent with the intention of Canada and its treaty partners with regard to the manner in which these conventions are to be interpreted by the parties thereto.

Section 1

Section 1 of the Bill will provide that the Act is to be referred to as the "Income Tax Conventions Interpretation Act".

Section 2

Section 2 of the Bill will provide that the term "convention" means each convention or agreement between Canada and any other country relating to income taxation. It will therefore apply not only to all existing tax conventions but also to those concluded in the future. It will also apply to all amendments to tax conventions which are generally made by way of an amending protocol or supplementary agreement or convention.

Section 3

Section 3 of the Bill will provide that to the extent that a term contained in a convention is not defined therein, or is to be defined by reference to Canadian domestic law, the term is to be given the meaning that it has for the purposes of the Income Tax Act as amended from time to time.

This provision has become necessary as a result of the recent Supreme Court of Canada decision in *Melford Developments Ltd. v. The Queen*. That decision related to the interpretation of the 1956 Canada–Germany Income Tax Agreement. The Supreme Court concluded that in determining Canadian tax with respect to a transaction, an undefined term contained in a convention is to be given the meaning that that term had for the purpose of the Canadian Income Tax Act at the date the convention was adopted and not any different meaning that it might have at a later date when the transaction takes place.

The purpose of section 3 will be to ensure that for the purposes of determining Canadian tax, the meaning of undefined words and expressions contained in Canada's double taxation agreements and conventions will evolve with the changes made to Canadian tax law.

Section 3 will not affect the interpretation of those terms that are fully defined in a convention. It will apply only to those words or expressions that are not fully defined in a convention or where the convention itself provides that the meaning of a term is to be determined, at least in part, by reference to domestic legislation. Most recent conventions concluded by Canada and other member countries of the Organisation for Economic Co-operation and Development contain a specific provision relating to interpretation. They are generally patterned on paragraph 2 of Article 3 of the 1977 OECD Model Double Taxation Convention on Income and on Capital. This paragraph deals with General Definitions and reads as follows:

> As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Neither the OECD Model Convention nor the commentary thereon deal specifically with the problem addressed by the court in *Melford Developments Limited,* namely, the relevant time at which the meaning of a word or expression is to be determined. Section 3 will address this particular issue directly. It will provide that for the purposes of Canadian taxation the terms of a convention are to be given the meaning that they have under the Income Tax Act as amended from time to time. Thus, for example, if the issue relates to the tax with respect to the payment by a Canadian company of a dividend to a resident of the other country and the other country and the term "dividend" is to be determined by reference to Canadian tax law, it would be given the meaning it has for the purposes of the Income Tax Act at the time the dividend is paid. The meaning at that time would include any subsequent amendment to the Act relating to dividends that is applicable to that time. This rule would not apply in the circumstances where the convention itself provides an exhaustive definition of the term "dividend". In such a case, and in the case of a conflict between the definition contained in a convention and that under the domestic law, the definition in the convention would ordinarily prevail. Thus section 3 of the Bill will not affect the provision, generally referred to as the "treaty override" or "inconsistency" section, in the implementing legislation for Canada's tax treaties, which provides that in the event of any inconsistency between the provisions of the convention and the provisions of any other law, the provisions of the convention shall prevail.

Section 4

Section 4 of the Bill will provide that non-residents who carry on business in Canada through a permanent establishment shall compute their business profits attributable to that permanent establishment in accordance with the rules contained in the Income Tax Act for the calculation of income from a business.

This section of the Bill will address a concern arising out of the interpretation of a provision reflected in a number of Canada's tax treaties relating to the deduction of business expenses. This provision will be patterned on paragraph 3 of Article 7 of the OECD Model Convention which reads as follows:

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

The principal purpose of this provision is to ensure that a deduction is not denied for general overhead expenses and other expenses relating to a business because they are incurred outside the country in which a permanent establishment is located. However, there is some concern that the provision as worded would allow a deduction for expenses including those that by their nature are not allowed under domestic legislation. It is not intended that this provision place a non-resident in a better tax position than a resident by allowing the non-resident a deduction in these circumstances.

Paragraph 4(b) of the Bill will clarify the scope of the corresponding provisions in Canada's tax treaties and ensure that they are not to be construed as allowing a deduction for those expenses that would not, if incurred by a taxpayer resident in Canada, be deductible in calculating his business income. Thus, a non-resident carrying on business through a Canadian permanent establishment will not be able to deduct those expenses – such as fines for criminal offences, eligible capital expenditures, the petroleum and gas revenue tax or provincial income or mining taxes or resource royalties – that would not be deductible for the purposes of the Income Tax Act if they were incurred by a person resident in Canada.

Paragraph 4(a) will clarify that a non-resident must also include in the calculation of the profits attributable to a Canadian permanent establishment all amounts that are required to be included by a resident in the determination of income from a business under the Income Tax Act.

Section 5

Section 5 of the Bill will contain definitions of certain terms that are found in most of Canada's tax conventions. The definition of the term "Canada" therein will be similar to the definition found in the Income Tax Act and will clarify that "Canada" includes the seabed adjacent to the coast of Canada over which Canada has jurisdiction. The decision of the Supreme Court of Canada in *Melford Developments Limited* has given added support to the argument that the definition of "Canada" in a number of conventions, particularly in the 1942 Canada–U.S. Income Tax Convention, is not broad enough to cover the continental shelf and the territorial waters.

Paragraph 5(b) of the Bill will provide definitions of the terms "immovable property" and "real property". Most of Canada's conventions have specific provisions dealing with immovable or real property. They generally provide that the country in which such property is situated has the right to tax the income from such property, including any profits or capital gains arising from its disposition. The purpose of paragraph 5(b) of the Bill will be to clarify that the treaty definitions of "immovable property" and "real property" include any resource interest or other property that is treated under paragraph 66(15)(c) of the Income Tax Act as a Canadian resource property.

Section 6

The last provision of the Bill will be a grandfathering provision. It will provide that for the purposes of conventions which came into force before November 19, 1974, the meaning of interest does not include guarantee fees paid pursuant to written agreements entered into before June 23, 1983. November 19, 1974 is the date on which the meaning of interest in subsection 214(15) of the Income Tax Act was enlarged to include guarantee fees. Thus, those taxpayers that have relied on the Supreme Court decision in *Melford Developments Limited* and have not deducted tax from guarantee fees paid to residents of treaty countries may continue to pay such fees pursuant to existing agreements, free from the non-resident withholding tax.

ERRATUM

In the article "Introduction of an Inflation-adjusted Tax Base in Israel", by J.F. Pick in 37 *Bulletin for International Fiscal Documentation* 6 (1983) at 259, the following printing errors should be corrected:

p. 262, right hand column, line 3 of para. 3 after new heading – instead of forms, read firms.
p. 263, Appendix A, first line of column 4 – instead of 62.22%, read 65.22%.
p. 263, Appendix B, the line which begins: "At 30% inflation . . ." should read "At 130% inflation . . ."

We apologize for any inconvenience to the reader.

The Future Financing of the Community[1]

THE E.E.C. "GREEN PAPER"

INTRODUCTION

1. The European Community is financed by resources which accrue to it as of right and as a direct consequence of its own policies. The current own resources system, consisting of agricultural and sugar levies, customs duties and an element of Value Added Tax of up to 1% of a uniform base, has served the Community well for twelve years. But the time has now come to consider its further development. In this present communication the Commission sets out some preliminary ideas on how this development might take place. The character of this communication is that of a discussion document, of a kind which is sometimes referred to as a "green paper". It describes various considerations affecting the development of the Community's financing system and lists a certain number of options which, at this stage of the Commission's reflections, seem prima facie suitable for further study. It does not, deliberately, contain specific proposals. The Commission will make such proposals, in the spring of 1983, in the light of its further internal considerations of the issues involved and of the reactions of the Council and of the Parliament to this communication.

2. This discussion document on the Community's financing system is presented to the Council and the Parliament in parallel with the speech which the President of the Commission will make before the Parliament on 8 February in which the Commission's policy priorities for the remainder of its Mandate will be set out. The Commission's ideas on the Community's financing system need to be appreciated in the light of its policy proposals. The Commission also emphasizes, as it has done on previous occasions, that the Community's Budget, with the financing of which this "green paper" is concerned, gives only a very partial picture of the reality of the Community and cannot in any sense constitute the only, or even the principal, touchstone by which the advantages of Community membership can be judged.

3. The Commission's proposals for the future financing of the Community will be designed to:

(a) provide the Community with the necessary resources and with the necessary financial flexibility and autonomy to respond to the increasing budgetary demands of its policies;
(b) develop the Community's financing system in such a way as to stimulate the further development of these, and new, policies;
(c) establish a financial framework which allows enlargement by Spain and Portugal to take place without prejudice to the acquis communautaire as it now exists and as the Commission has proposed it should be developed in the context of enlargement;
(d) reinforce the Community's internal cohesion by contributing to the correction of budgetary imbalances, as demanded in various resolutions of the European Parliament.

4. The Commission has on a number of occasions explained why it believes an extension of the Community's own resources to be necessary and why it cannot accept that the present ceiling should constitute a permanent constraint upon the growth of the Community's Budget. In this programme speech of February 1981 to the European Parliament the President of the Commission emphasized that the Community could not remain simply a Community of one percent. In the first place, this is because of the need to safeguard the maintenance of the full range of the Community's existing policies.

Following the presentation of the Green Paper of 4 February 1983 (Doc. COM(83) 10 final), the Commission of the European Communities on 5 May 1983 presented to the Council and the European Parliament specific proposals for extending and diversifying the Community's system of own resources (COM(83) 270 final). The Commission's proposal takes the form of a new Council decision replacing the one of 21 April 1970 which set up the current system.

The basic premise is that the present range of own resources consisting of agricultural levies, customs duties and VAT should be retained and further developed. The principal proposals entail: the abolition of the 1% ceiling on VAT; that this ceiling should be basically 1.4% but it may be increased by tranches of 0.4% provided a unanimous Council decision has been taken and a qualified majority in Parliament approves this decision; that part of the Community's VAT revenues should be paid in the form of modulated VAT with varying rates applying to the Member States; that customs duties on imports of the European Coal and Steel Community products should accrue to the Community rather than to the Member States; and that reimbursement to Member States of 10% of the cost of collecting customs duties and agricultural levies should no longer be automatic.

Because of their significance these two documents are reproduced in this issue of the *Bulletin*.

1. Communication from the Commission to the Council and to the European Parliament, Doc. 4 February 1983 (COM (83) final).

The Community is already living in the shadow of the exhaustion of its current financial resources; and whatever the actual level of expenditure envisaged for any budget year, the Community needs to have in reserve a certain margin of potentially available resources so as to safeguard, within an overall budgetary framework, the security and continuity of all its policies.

5. In addition, the existing range of Community policies needs to be developed further. The Commission presented ideas for the development of Community policies in its Mandate Report and will amplify and extend these in the Programme Speech which its President will deliver to the European Parliament on 8 February 1983. In brief, the Commission envisages:

(a) the intensification of the Community's energy and industrial strategy and the expansion of Community expenditure on research and development and on innovation projects;
(b) more systematic and extensive use of Community financed structural expenditure through the Regional and Social Funds, as well as the development of other structural expenditure such as FEOGA Guidance and Fisheries and Mediterranean programmes;
(c) the development of a substantial Community financed transport infrastructure programme;
(d) the achievement within the next ten years of a Community development aid programme representing 1/1000 of the Community's Gross Domestic Product;
(e) the maintenance of the Commission's aim, which is that agricultural expenditure should grow more slowly than the Community's own resources assessed over a period of several years.

6. In assessing the contribution which particular forms of new resource can make to the attainment of the objectives set out in paragraph 3 above the Commission starts from the premise that the development of the Community's financing system must be viewed in connection with the development of the Community's policies, particularly its expenditure policies. The Commission has long emphasized the need to expand the Community's policies in the non-agricultural area and the effect of this would be to produce a better balance of expenditure within the Community Budget. In this context, the Commission regrets that, as a result of the current stagnation of Community decisions in many areas, the relationship between the development of national and Community policies is not moving as expected in favour of Community programmes.

7. In making these proposals, the Commission does not proceed from the assumption that an increase in the size of the Community's Budget is desirable simply for its own sake. The Commission recognizes the severe economic constraints facing all its member states and has itself emphasized the importance of budgetary discipline in the public sector. All expenditure at Community level should be rigorously scrutinized with a view to showing that it represents a cost-effective alternative to national programmes. Indeed, in the Commission's view the relationship between Community expenditure and that of national governments could in certain appropriate cases be more systematically examined and publicised.

The significance of economies of scale needs to be given greater attention. In particular, in the field of policies designed to promote structural adjustment as well as industrial and technological innovation, purely national programmes entirely financed by national budgets risk in many cases not to be adequate because of budgetary restrictions and limitations of scale. A higher level of Community financing can in some cases not only avoid the waste of scarce public resources but also provide an incentive for greater opening of the market. It should be possible to show the people of Europe that any increase in the Community's resources should not automatically involve an additional burden on the European taxpayer; on the contrary, in many cases the corollary of increased Community expenditure should be a reduction in expenditure at the national level.

8. There are no potential additional new forms of revenue available to the Community which flow as automatically from its policies as do the traditional own resources of customs duties and agricultural levies. The Commission has therefore sought to identify those new resources which best reflect the overall interest of the Community, which enhance the attraction for all Member States of full participation in Community policies and which best ensure a coherent relationship between the Community's revenues and its pattern of expenditure.

9. In order to allow the development of the Community's present policies to be maintained with an adequate margin of security, and in order to promote the growth of those additional policies and expenditures which will be needed in the future, including in the context of enlargement, the Commission believes that a better diversified system of financial resources is required.

10. Such a diversification would also contribute to the mitigation of the budgetary problems to which the Commission referred in the Introduction to its Preliminary Draft Supplementary Budget No. 1 1983, and for which the European Parliament in its Resolution of 16 December 1982 called for a lasting Community solution.[2] The Commission made clear that it was alive to the concern expressed by Parliament and to its desire to see the ad hoc solutions of recent years replaced by a permanent arrangement for strengthening Community policies and would accordingly be presenting proposals in the near future for developing these policies and for introducing a more diversified system of own resources.

11. A further factor which has intervened in the years since the establishment of the current own resources system, is the emergence of a directly elected European Parliament. The Parliament's role as part of the Budget Authority is clearly defined in the Treaty. In the Commission's view, it is essential that in any further renewal of the system proper provision should be made for the exercise by the directly elected European Parliament of budgetary powers and responsibilities which adequately reflect its status.

2. In its resolution of 16 December 1982, the European Parliament called on the Commission and the Council "to submit as soon as possible new financial and budgetary proposals which provide an effective follow-up to the Mandate of 30 May and lay the basis for a lasting Community solution to the unacceptable situations which have arisen for a number of Member States".

12. The following paragraphs discuss, successively, possible sources of general revenue for financing the Community Budget, under the headings of VAT, progressivity and sources of revenue related to agricultural indicators; possible sources of revenue related to the financing of specific policies; revenues which accrue incidentally as the consequence of the Community's agricultural and commercial policies; the role of borrowing and lending; the feasibility of the introduction of some kind of financial equalisation or transfer system; and the role of Parliament. Annexed to this communication is a brief commentary on certain other financing ideas which the Commission has examined but which do not seem, in present circumstances, to be feasible as Community resources; a fuller analysis of the idea of financial equalisation; and a discussion of the integrity and autonomy of the Community Budget.

13. In setting out these ideas for a diversification of the Community's financing system, the Commission starts from the assumption that the existing range of own resources will remain intact; and that any new forms of revenue would constitute an addition to this range.

SOURCES OF GENERAL REVENUE

Value Added Tax

14. Of all the possible sources of additional general revenue for the Community Budget Value Added Tax has obvious attractions. It is an existing own resource capable of being linked directly to the taxpayer. In principle the tax base is already harmonized. The necessary mechanisms for assessment, payment and control are in place, work relatively well and ensure a large measure of continuity in financing the Community's Budget expenditure. Moreover, VAT is levied on consumption and thus offers a very large reliable base, generating high revenue from a low tax rate. These revenues are adequately buoyant. For the Community as a whole, the VAT base can be expected to grow over time more or less in proportion to Community GDP. Finally because of the mechanism whereby VAT taxpayers must deduct tax already paid in order to arrive at their own net VAT bill, VAT enjoys an element of self-checking: it is thus to some degree less subject to evasion than other broadly based tax options. Thus the increase or removal of the 1% ceiling would provide a durable and reliable source of revenue which would be capable of assuring a considerable development of community policies. It also roughly reflects the relative wealth of the Community's Member States.

15. Further measures are still required to perfect the development of the VAT system so as to enable it better to correspond to the original ideal of a direct relationship between the taxpayer and the Community. For example, although the VAT base is harmonized in principle, Member States currently enjoy a variety of temporary derogations from it which have to be compensated by financial payments based on approximate calculations of the tax which would have been due. Moreover, under transitional arrangements VAT is not perceived directly from individual taxpayers but on the basis of a weighted average involving a considerable degree of statistical estimation applied to the total revenue collected. The Commission will maintain and reinforce its efforts to secure the complete phasing out of those transitional anomalies. It is VAT which should, in the Commission's view, remain for the foreseeable future as the backbone of the Community's financial autonomy. The Commission envisages therefore that, as the Community develops a fuller range of expenditure policies additional VAT revenues beyond the 1% ceiling will be necessary, together with a more diversified system of Community financing.

Progressivity

16. The Commission has examined the desirability and feasibility of introducing an element of progressivity into the Community's revenue system. The introduction of such a concept would be consonant with the notion of equity which is basic to all public financing systems. The political purpose of its introduction into the financing of the Community Budget would be to contribute, in a modest way, to the convergence of Member States' economies by ensuring that each Member State's liability for payments into the Community Budget was modulated either upwards or downwards in relation to that Member State's level of prosperity. It would mean that those Member States with an above-average wealth (measured most conveniently by GDP per capita) would have an increased requirement for revenue contributions whereas less prosperous Member States would be relieved. There are two broad ways of introducing progressivity into the Community financing system; either an element of progressivity could be added into the VAT system; or Member States could be progressively taxed on the basis of GDP.

17. The addition of an element of progressivity into the VAT system would mean the application of a corrective mechanism to the calculation of the VAT rate, which follows immediately after the adoption of the Budget. Such a mechanism could take two forms:

- a correction of VAT in function of the per capita GDP of each of the Member States as a percentage of the Community average. This would mean that each Member State would be allocated its own VAT rate and that the actual rate applied would differ from one Member State to another;
- a correction of the VAT rate in favour of certain Member States only (e.g. a rate reduction in favour of those whose GDP per capita fell below the Community average). This mechanism would be similar to that which is at present applied, on a transitional basis, to Greece.

18. Both these methods of applying a corrective mechanism to VAT, neither of which has any counterpart in existing national VAT legislation, would require amendment to the existing own resources legislation, and both would further stretch the tenuous link between the VAT taxpayer and the Community. The replacement of a single VAT rate by ten different rates would be a major innovation which would change significantly the character of the own resources system.

19. If it were thought preferable to introduce an element of progressivity without weighting the VAT yield in this way, an alternative method would be to include in the Community's revenues, in addition to the consumption based VAT, another source of income reflecting directly the prosperity of Member States. GDP per capita is widely recognized as a measure of prosperity and the Community has made explicit use of it for some years. A tax on Member States based on GDP could be modulated in a progressive sense by the application of a coefficient of elasticity to the percentage of contribution which the uncorrected relative GDP shares would represent. Such a progressive GDP tax would fulfil more directly the objective of promoting economic convergence in the Community by relating liability for payment to capacity to pay; and would do so in a way which avoided prejudice to the smooth operation and further development of the VAT element of the Community's present own resources.

20. Although a progressive GDP tax on Member States would thus have a number of attractive characteristics as a source of general revenue it would suffer from one significant drawback: it would be seen as a partial return to the system of financial contributions which applied before the own resources decision of 1970 and thus as a political step backwards.

21. The introduction of the concept of progressivity whether by a modulation of VAT or through a progressive GDP tax, would pose a number of technical and political difficulties. It would be necessary to agree upon how the progressive indicators of taxable capacity should be defined. Moreover, in order to have any significant impact upon the Community's budgetary problems, progressivity would have to be introduced on a scale far in excess of that which has usually been discussed in this context or than which seems realistic in current circumstances.

Sources of revenue related to agricultural indicators

22. Agricultural policy, the only policy actually integrated, accounts for a large slice (around 65%) of the Budget. In future increasing provision will need to be made in the Budget for the new policies which the Community will have to introduce and to give effect to the forthcoming enlargement. During this phase of gradual diversification it would be appropriate for a new type of resource, drawn from the whole economy but based on agricultural parameters, to be added to the present own resources system so as to bring it more into line with the pattern of expenditure. The introduction of such a new type of resource would have the further advantage of avoiding situations in which discussions of financial problems impose artificial constraints into the normal operation of the CAP.[3]

23. The purpose of this new resource, to be levied from the Member States, would be to contribute to the financing of the whole of the Community's expenditure, i.e. it would not be linked specifically to any one part of the Budget; but it would be based upon indicators of an agricultural nature. The income from this new resource would need to be sufficiently substantial to make a worthwhile contribution to the mitigation of some of the Community's budgetary problems. But it should be conceived as a transitional, rather than a permanent element in the Budget and its form should therefore be such as to ensure a gradual reduction in its relative size, and eventually even its complete disappearance, in parallel with the development of a better reflection in expenditures of the various Community priorities suggested by the President in his 8 February speech. Amongst the hypotheses which might be envisaged, the size of the revenues which the new resources should generate might therefore be calculated in such a way as to correspond to the amount of agricultural expenditure in excess of a certain percentage of either the total Budget or the total available own resources.

24. The calculation of this new resource could be made in a number of ways in relation to Member States' shares in the Community's overall agricultural production. The elements to be taken into consideration could include, for illustrative purposes, the final or added value of agricultural production in each Member State, the value of production under regimes benefiting from particular forms of Community support or a set of values modulated in accordance with the nature of such regimes. Account would have to be taken of the situation of certain Member States and their regions whose general level of prosperity is low but whose economies are particularly dependent upon agriculture.

Other possible sources of general revenue

25. The Commission has examined a number of ideas for other possible sources of general revenue. For the reasons explained in Annex I none seem prima facie suitable at this stage as a Community resource, either because the necessary tax rate is inadequately harmonized or because the economic consequences of the imposition of a Community tax in the area concerned would be unjustifiably damaging.

Revenues linked to specific policies

26. In addition to its general revenues it might be advantageous for the Community to dispose of certain minor sources of income linked to the development of specific policies. The example of the European Coal and Steel Community Budget has shown that under certain conditions and up to a certain point expenditure in connection with policies in particular sectors can satisfactorily be financed by levies from those same sectors. Energy, research and industry suggest themselves as sectors where arrangements on these lines might be feasible. The Commission is not at this stage thinking in terms of specific practical cases: this is not a mode of financing for general use, and the desirability of employing it to fund certain items of expenditure would have to be appraised case by case according to the particular features presented by the case concerned. In this context, it would be appropriate to decide on the affectation to the Community of the customs duties on ECSC products.

3. *Editor's note:* Community Agricultural Policy.

Incidental revenues

27. The Community Budget will continue to benefit from the revenues accruing from customs duties, agricultural levies and sugar levies. The yield of these traditional own resources is substantial (currently around 8.139 MECU per year) but fluctuates from year to year and is gradually declining in accordance with the downward trend in real terms of customs duties. Various policy changes in this field could produce additional revenues in the future, for example the introduction of a tax on cereal substitutes or of a tax on oils and fats. The justification of such taxes in terms of agricultural policy is not discussed here. But neither would be appropriate as a source of regular finance for the Community Budget. A tax on cereal substitutes would have a low yield and would be subject to unpredictable fluctuations. A tax on oils and fats would, if introduced, be geared to covering expenditure necessary to maintain the level of olive oil consumption.

28. Similarly agricultural co-responsibility levies, though they can yield not inconsiderable amounts of revenue in certain years, are designed as tools of agricultural management, not as primary sources of revenue. The basic idea behind the co-responsibility levy as it is now applied in the milk sector, is to contain the surpluses above the production target by making the producers participate financially in the market regulation mechanisms. So far, this levy is considered as an earmarked resource. In the interests of Budget transparency it ought to be entered in the Budget as revenue. The resources accruing from the co-responsibility levy depend on the trend in surplus products, and they therefore drop to the extent that the objectives of regulating the agricultural markets are attained.

The role of borrowing and lending

29. In the Commission's view, loans cannot substitute for Community own resources. On the other hand, they have an important role to play for increasing the Community's participation in the financing of projects which correspond to the objectives of Community policies. In fact they already play an important role in the financing of some policies, a role which should be developed further in the future. The development of this role can be facilitated by an increase in the resources of the Community since the Budget provides guarantees and in some cases interest rebates for those loans which have reached a substantial level.

FINANCIAL EQUALISATION OR TRANSFER SYSTEM

30. On 15 November 1979, the European Parliament adopted a Resolution (the Lange Resolution) on the communication from the Commission of the European Communities entitled "Convergence and Budgetary Questions". This Resolution was based on a number of considerations which remain relevant today and set out various basic principles of European finance. The Resolution:

- considers that a new and lasting system of financial equalisation between the Member States within a Community framework – based on the concept of per capita gross domestic product and organised within the framework of the Community Budget – can effectively contribute to the furtherance of the efforts at convergence made through the common policies;
- calls on the Commission . . . to draw up a formal proposal based on the Community system of equalisation described above and on proposals for convergence between the economies.

This Resolution was followed in 1981 by a Resolution on the Community's own resources (the Spinelli Resolution) which stated that the Budget should have a more distributive role and placed the emphasis more on the modulation of resources and the development of structural policies.

31. The Commission fully agrees with Parliament as regards the following considerations and principles:

- that convergence between the economies can result only from the development of genuinely common policies and from the coordination of the policies pursued by the Member States in the economic and monetary spheres, and also in the regional, social, agricultural and other sectors;
- that the financial imbalances which characterize the present situation and the burdens which they place on certain Member States are a serious problem which calls for an immediate solution;
- that it considers "inadequate, given its incompatibility with the spirit of the Treaties, any solution based on the concept of a fair return, calling into question the principle of own resources or resorting to non-budgetary financial transfers".

32. In considering the possible application of a financial equalisation system to the Community, the Commission has had to bear in mind the differences which exist between the Community as it is today and those federal states, where such a system operates. Financial equalisation in those states involves arrangements on both the revenue and expenditure side, designed to establish a unitary level of provision of certain public services. As regards the Community's revenues, the introduction of a better diversified financing system would correspond with some of the objectives of financial equalisation particularly insofar as it led to a reduction in the liability for contributing revenue of the Community's less prosperous Member States.

33. As regards the Community's expenditure, it is clear that a Budget accounting for scarcely 1% of the GDP of the Community obviously cannot bring to bear a sufficient volume of resources to impact significantly upon the full range of the Community's problems of regional differences and economic non-convergence. It is clear too that if a new mechanism were to be introduced into the Community Budget, there would have to be adequate guarantees that the transfers paid over would actually promote convergence. This would seem automatically to rule out a system of unconditional transfers, at least within the Community's current institutional framework.

34. A form of equalisation mechanism, involving transfers on the expenditure side additional to those under the

Community's structural funds, could nonetheless be a useful new element in the Community's Budget. Such a mechanism could be geared to two purposes. It could provide additional financing so as to allow certain Member States to participate more fully in economic programmes reflecting agreed Community priorities. The interest rate subsidies disbursed in Ireland and Italy in the context of their participation in the European Monetary System are an illustration of this kind of possible transfer. Or its application could be limited to a certain number of the least prosperous Member States. The resources so transferred would need to be subject to the necessary consistency with Community policies and subject to proper Community control.

35. An equalisation mechanism of this kind would perhaps be more politically attainable in the short term. The sums required for its operation need not be excessively large. A transfer of resources limited in overall size could still have a significant economic effect upon the least prosperous Member States concerned.

THE ROLE OF PARLIAMENT

36. Any new development of the Community's financing system should, in the Commission's view, reflect and enhance the role of the directly elected European Parliament as one branch of the budgetary authority.

37. Article 201 of the EEC Treaty stipulates that the creation of new own resources is decided by Council, acting unanimously after consulting the European Parliament, and subsequently ratified by the Member States. The Commission proposed in 1973 an amendment to this Article, designed to enable the Institutions of the Community to create additional sources of revenues without having to obtain ratification by national Parliaments. This proposal covered three points: the Commission should examine in what manner new revenues could be raised; in every fifth year the Council, after receiving a report from the Commission and consulting the Parliament, should examine whether and in what manner new revenues should be introduced for the Community; finally, the Parliament acting on a proposal of the Commission and after the Council had given its unanimous assent, might, by a majority of its members and of three-fifths of the votes cast, amend the upper limit for existing resources or make provisions for new resources for the Community.

38. This proposal of the Commission has been on the table of the Council for almost ten years. It clearly raises issues of considerable domestic sensitivity in some Member States. Nonetheless, the Commission maintains its view that if the Community is to develop as a viable political and economic entity, its institutions must have some greater degree of independence in their revenue raising powers. Whatever new sources of revenue are created, they should be of such a kind as to sustain the development of the Community for a secure period of time, without the automatic requirement for national ratification procedures. The Commission would not, for example, wish to see the 1% VAT ceiling replaced simply by a new ceiling so low that it too would soon be reached.

39. It is not in the context of the present green paper that the Commission wants to take a position on ways in which Parliament's powers in the annual budgetary procedure can be brought up to date. However, the Commission is aware of the potential relationship between decisions concerning revenues and those concerning expenditure. It is taking note of the work which has started within Parliament on the way the budgetary procedure could be improved for expenditure as well as revenues. The manner in which the Commission will put forward its proposals on developing the Community's financing system, i.e. the presentation, first of this consultative document, has been chosen in part so as to enable the Commission to take due account of Parliament's views. The Commission would wish to associate Parliament as closely as possible with the further refinement of its ideas. The Commission envisages that these ideas will in any event be a subject for the conciliation procedure between the institutions.

ANNEX I

FORMS OF REVENUE WHICH DO NOT SEEM, IN PRESENT CIRCUMSTANCES, TO BE FEASIBLE AS COMMUNITY RESOURCES

1. Excise duties

The Commission does not consider that excise duties on cigarettes or alcohol would be a suitable source of revenue for the Community. They would not facilitate the realisation of any Community policy. For alcohol excises, there is the additional problem of the lack of harmonisation of duties on beer, wine and spirits where the Commission's proposals have not yet resulted in a Council decision.

2. Corporation tax

The Commission has long advocated the harmonisation of corporation taxes. For Community involvement in the taxation of corporations, three hypotheses could be considered:

- the replacement of national corporation tax systems by a Community tax administered directly by the Community;
- allocation to the Community Budget of part of the yield of national corporation taxes;
- the introduction of new taxes on companies earmarked for the specific purpose of financing certain expenditure from which companies benefit particularly in the research sector.

At this stage, it appears that corporation tax is not a suitable source of community finance in the near future. This would be practical only in the long term since it would require a uniform base on which the tax could be imposed. Such harmonisation will be extremely complex and so take a considerable amount of time. The Commission is engaged on the necessary preparatory work but would find it difficult to present a formal proposal until the Parliament has given an opinion on the Commission's 1975 proposal on Harmonisation of Systems of Company Taxation. The Parliament gave an interim opinion in 1979 but has not returned to the issue.

The third hypothesis is dealt with in paragraph 26 of the main text.

3. Income tax

The use of personal income tax, the only real progressive tax, as an own resource would depend on at least the following conditions being met:

- harmonisation of its scope, that is definition of the natural and legal persons to be taxed;
- harmonisation of the base which requires common rules to determine personal income, not just of individuals, but also of industrial and commercial firms and agricultural enterprises not subject to corporation tax.

The complexity of this harmonisation and its political implications probably mean that action is unlikely to be taken in the foreseeable future in this field.

4. Taxation of hydrocarbons

The benefit of a tax on hydrocarbons must be assessed in a general economic and political context. In the event of a future decline in world market prices of oil, some fiscal intervention might be appropriate on these grounds. The Commission, in its communication COM(81) 555, has put the main emphasis on the coordination of national tax policies in relation to the Community's economic and energy policies. Although it is possible that, in addition to such national coordination, the imposition of a specific Community tax might merit further study, such a tax, even if introduced, could not be expected to yield significant amounts of revenue.

ANNEX II

FINANCIAL EQUALISATION

In the light of the suggestions often made (particularly in the context of the Lange Resolution of November 1979) for the introduction of financial equalisation arrangements in the Community financing system, the Commission has thought it useful to set out briefly:

- what is meant by financial equalisation and what is its purpose;
- how financial equalisation operates in certain existing federal systems, notably Switzerland and the Federal Republic of Germany;
- what conclusions might be drawn for the Community from the operation of these financial equalisation arrangements.

Financial equalisation in the strict sense means a systematic process of financial transfers directed towards the equalisation of the Budget capacity or economic performance of different levels of federal governments. A purpose of such equalisation is to enable states to ensure the provision of a comparable range and quality of public services for their citizens while maintaining broadly comparable fiscal burdens in the form of standard rates of taxation and other charges.

Financial equalisation systems exist in practice in all major western federations: Germany, Switzerland, Austria, the United States, Canada and Australia. They are of broadly two types: horizontal systems where the equalisation takes place between the various subsidiary levels of government; and vertical systems where it takes place through the fiscal activities and powers of the central government. Equalisation systems normally have two elements: general purpose equalisation on the revenue side and a specific purpose grant system (e.g. for social services, health, education or transport) on the expenditure side. The precise mix and scope of the system varies considerably from one federation to another. But problems may arise when general and specific purpose equalisation payments are made in conjunction: the effect of one form of payment may in some circumstances either duplicate or be incompatible with the effect of the other.

In Switzerland, there exists a system of vertical financial equalisation. Subsidiary authorities (in this case the cantons) receive varying payments from the Confederation in accordance with specifically defined needs. The cantons have a direct share in the Confederation's revenue (where revenue equalisation operates) and in its expenditure, in the form of federal grants (where expenditure equalisation applies).

Revenue equalisation covers the number of taxes recorded in the Swiss constitution which the Confederation has to share with the cantons. The shares which the Confederation and the cantons as a whole receive from each source of taxation are laid down by the constitution. Revenue equalisation applies only to the distribution of the cantons' share between the individual cantons. Different scales of apportionment are laid down for each tax. The bulk of tax revenue is divided up in proportion to the canton's population (though its defence tax capacity is also taken into account).

No conditions are imposed on how the cantons may use the funds received from federal taxes (though conditions are attached to the use of the separate Federal expenditure grants to which the cantons are required to make a contribution of their own). Equalisation on the expenditure side applies, in that the cantons are granted varying rates of aid. The Confederation's percentage contribution to the canton's programmes or projects is mainly based on its fiscal capacity index. This index, mainly based on tax burden, taxable capacity, size of population and geographical/regional factors, gives each canton a rating on the basis of which its requirements for additional funds in relation to those of the other cantons are assessed.

The Swiss system of equalisation avoids direct payments from one canton to another. Financial equalisation operations are always conducted centrally and are based on criteria which take into account the financial requirements and fiscal capacity of the cantons. This gives greater protection for the cantons' fiscal independence than would a horizontal system of financial equalisation. But the corollary of this greater independence is a wider range of discrepancy between the cantons in the provision of public welfare services.

In Germany, in addition to a vertical equalisation arrangement through the VAT sharing system which increases the tax capacity of each 'Land' to a level of 92% of the average, there is a horizontal system of inter-Land equalisation. The German 'Länderfinanzausgleich' is unique in the world in that it provides for horizontal payments from fiscally rich to fiscally poor states without affecting the federal Budget. It has been created in special post second world war circumstances where a particularly high degree of solidarity between the 'Länder' was required in order to cope with the problem of rebuilding the German economy and absorbing the refugees from the lost territories.

The 'Länderfinanzausgleich' is designed to ensure that a below average 'Land' always reaches 95% of the per capita average tax receipts of all 'Länder' and that a 'Land' required to make equalisation transfers does not, as a result, fall below 100% of the average. The level of equalisation contributions/grants is determined by the relationship between a tax capacity indicator ('Steuerkraftmesszahl') and an expenditure need indicator ('Ausgleichmesszahl').

The 'Länderfinanzausgleich' is part of a more general financial equalisation between the 'Länder'. On the revenue side, in addition to the VAT sharing system additional payments

('Ergänzungszuweisungen') are made by the 'Bund' to the less prosperous 'Länder'. Finally, on the expenditure side, a system of specific purpose grants exists in the areas of university and hospital construction, regional policy, agricultural structural policy, coastal protection, urban development, etc.

In view of the special circumstances which led to the horizontal German 'Finanzausgleich' and the fact that this is operated outside the federal Budget, it can hardly be regarded as an appropriate model for a new Community system.

Some kind of vertical system might seem more promising as a possible model for the Community. Nevertheless a number of preconditions would need to be fulfilled: first, the Community would have to have the necessary budgetary means at its disposal for making any equalisation payments. At the moment, when the Community is not a federal state and because its powers are limited, its Budget, in contrast to the Budget of federal states, is smaller than the Budgets of its constituent members and the scope for financial equalisation is consequently restricted from the outset. Secondly, an agreed overall political aim and objective method for calculating the equalisation payments would have to be set up and it would need to be geared to the objective of convergence. Finally, an effective monitoring in respect of this objective would have to be put into place.

The Lange Resolution calls for a "new and lasting system of financial equalisation between the Member States within a Community framework – based on the concept of per capita GDP and organised within the framework of the Community Budget". This would imply not a full fiscal equalisation system as practised in existing federal states, but a more limited mechanism geared towards partial economic equalisation or transfers.

The existing Community structural funds (particularly the Regional and Social Funds) already constitute a first step in this respect. But it would of course be possible to develop the idea of resource transfers further and to introduce a more far-reaching transfer mechanism expenditure into the Community Budget.

Such a mechanism, linked to the aim of economic convergence, would however need to be geared to the following considerations:

- the revenue raising capacity;
- identifying the public finance functions for which a need for resource transfers exists at the level of the Community;
- in respect of the selected functions
  - the measurement of expenditure needs
  - the degree of transfer appropriate

The political and technical complexities involved in this should not be under-estimated. In existing federations, equalisation systems have evolved over a long period of time and have a well-established tradition. The Community is however more heterogeneous in economic capacities, policies and traditions than existing federations. It is probably unrealistic therefore to envisage at this stage more than a modest step in this direction, perhaps by the introduction in complement to the existing structural funds of a special fund geared either to the provision of additional finance for activities reflecting particular Community priorities or limited in application to the Community's least prosperous Member States.

ANNEX III

THE GLOBALITY AND AUTONOMY OF THE COMMUNITY'S BUDGET

In addition to the Community's General Budget, two other Budgets exist through which expenditure on Community policies is disbursed, namely the European Development Fund and the operational Budget of the European Coal and Steel Community. For both of these separate Budgets there are different financing arrangements. The EDF is financed by special contributions by Member States calculated according to a political key. The ECSC operational Budget is financed mainly by a production levy on coal and steel enterprises (although in recent years special contributions from Member States or from the General Budget have also been made).

The existence of sources of finance for Community expenditure outside the General Budget is at variance with the principle of the unity of the Budget and has been criticised by the European Parliament. As regards the European Development Fund, the Commission is committed to supporting its full budgetisation and is proceeding on the presumption that the successor to the Lomé Convention, which will enter into force in 1985, will be so budgetised. In addition to the issue of principle, there are practical advantages to this. The distinction between associated and non-associated developing countries can no longer be rigidly applied in the budgetary field. Programmes covering both sorts of countries have already been proposed by the Commission under the General Budget despite the separate existence of the EDF.

As regards the ECSC, however, the Commission remains sceptical about the advantages of incorporating its Budget into the General Budget. The reasons lie in the separate juridical existence of the Paris Treaty and the particular characteristics of the ECSC Budget, for example its role in support of borrowing and lending and the direct relationship which it embodies between sources of revenue and areas of expenditure. Nonetheless, it seems likely that the demands of Community expenditure in certain ECSC areas, particularly the steel social field, will be so acute over the next few years that the ECSC Budget will be unable to cope with them. This means either that the ECSC Budget will need to be supplemented significantly by revenue from the General Budget or from Member States; or that certain types of expenditure in the social and other fields, hitherto falling under the aegis of the ECSC Budget, will need in the future to be implemented through the General Budget.

There is in any event one further anomaly in the current ECSC and Community Budget arrangements which in the Commission's view ought to be speedily rectified. Customs duties on ECSC products are not paid over like other customs duties to the Community, but are retained by the Member States. They amount currently to around 50 MECU per year. The Commission and the Parliament have for some time urged the transfer of these duties to the Community, but the Council has not so far agreed.

As regards the financial autonomy of the Community, there are a number of areas where the Community's current powers over its own resources are severely restricted and where the re-

4. *Editor's note:* FEOGA are the French initials of the European Agricultural Guidance and Guarantee Fund. There are two sections: the Guarantee Section which provides credits towards the structural reform of agriculture and the Guarantee Section which intervenes to regularize the internal market and provides for export refunds compensating for the difference between Community and world market prices.

moval of such restrictions would constitute a logical strengthening of the Community's present competence. The first set of restrictions concerns the availability of own resources and other revenue derived from Member States. The Community does not in practice freely dispose of such revenues at the present time. They are not placed unconditionally and definitively at the disposition of the Community but may only be withdrawn from the accounts with the Member States' treasuries to the extent necessary to cover cash resource requirements arising out of the implementation of the Budget. These accounts bear no interest and the Commission is prevented from depositing the funds in them in interest bearing accounts. Moreover, any balance between actual income and expenditure at the end of the year is not retained by the Community but must instead be entered in an amending Budget of the following year: the balance is thus in effect returned to the Member States.

Similarly, when Member States send to the Commission the statements of their VAT bases for the preceding year, and pay or are refunded the difference between the actual amounts due and the provisional amounts made over, these payments or refunds are immediately entered in an amending Budget.

This situation reflects the system whereby the Budget was financed entirely by financial contributions from Member States, not a system of true Community own resources. Removal of the restrictions in question would be relatively easy, as they are contained in regulations and their modification would not therefore require ratification by Member States' Parliaments. The Commission has already submitted proposals of a limited nature to improve the situation. In its suggested modifications to the Financial Regulation it proposed that the balance of a Budget year could be kept for a full further year before being entered in an amending Budget. And in its proposals for amending Council regulation number 2981/77 implementing the decision of 21 April 1970, it proposed that the Commission's accounts with Member States' treasuries be interest bearing.

A further budgetary innovation which, in the Commission's view, merits study, relates to unused FEOGA[4] Guarantee appropriations. In the Commission's opinion such unused appropriations, which because of the volatile and unpredictable nature of agricultural expenditure are bound occasionally to occur, could appropriately be placed, either in full or in part, in a reserve which could be used to cover additonal FEOGA Guarantee financial needs in a future year.

THE COMMISSION'S PROPOSAL

Draft Decision on Own Resources[1]

1. In its communication of 4 February 1983 the Commission explained the reasons why it believed that an extension and diversification of the Communities' system of own resources was necessary, and set out the considerations which, in its view, should guide the choice of new sources of revenue.

2. First and foremost, the Community today is living under the threat of the exhaustion of its financial resources. The appreciable rise in agricultural expenditure in the past few months has further exacerbated the situation since the Green Paper was issued. The supplementary Budget which the Commission will be proposing in the near future will use up most of the available margin of own resources for the current year.

For 1984, in the light of the forecast of agricultural expenditure and in view of the need to continue the development of Community policies in priority sectors, the Commission has to propose that all the available resources be taken up, leaving only a very small safety margin.

What is at stake today is nothing less than the preservation or the normal operation of all the Community's policies. The purpose of the own resources system was to afford security and continuity in these policies: it cannot be allowed to become a permanent threat to their development.

3. The development of the Community's policies is an objective shared by both the Council and Parliament. The Council stated this expressly in its Mandate to the Commission of 30 May 1980. Parliament has regularly made this balanced development one of its central preoccupations. When presenting the Commission's programme to Parliament on 8 February, the Commission President described the approach the Commission wished to see adopted in developing such policies, an approach which Parliament welcomed and which is at the centre of the Council's present work.

4. The extension of Community policies and hence of the Community Budget does not conflict with the need for budgetary stringency which is facing all the Member States today. When it proposes action at Community level the Commission's aim is to achieve a more cost-effective solution than could be offered by purely national programmes. According to the sector concerned, Community measures can either replace national projects or enable them to be coordinated and dovetailed in overall programmes making for greater efficiency. The Commission's most recent proposals – research and development programmes on information technologies, an outline programme of Community scientific and technical activities, a Community programme for promoting youth employment – are just a few examples of this. Economies of scale and closer European cooperation or integration often go hand in hand.

5. As well as seeking to develop new policies, the Commission has constantly sought to ensure the most economical management possible of existing policies, and in particular of the common agricultural policy. The guidelines it set out in its report in June 1981 in response to the Mandate of 30 May would, if promptly implemented, have cut back the increase in agricultural spending to a slower rate than that of the Community's

1. Communication from the Commission to the Council, Doc. 5 May 1983, COM (83) 270 final.

own resources. The Commission expects the Council in its decision on farm prices for the year ahead to give a clear signal of its intentions in this regard. For its part the Commission will not hesitate to propose additional measures should there be signs of further increases in agricultural expenditure not warranted either by the Community's internal requirements or by the need to preserve its traditional trade with its main trading partners. The extension of the Community's own resources will not interfere with this policy line. It could be the Council's opportunity to confirm it.

6. The extension of Community policies in non-agricultural sectors, coupled with a better control of agricultural production, will eventually bring a better balance of expenditure into the Community Budget. Such a change cannot come about overnight, for it would be neither realistic nor responsible, in present circumstances, to propose a major increase in Community spending. For this reason the European Council itself has accepted that the Commission's proposals on new own resources should contribute at once to the correction of Budget imbalances, a view shared by the European Parliament.

7. The Commission is accordingly proposing that the 1% ceiling for VAT resources introduced by the 1970 decision be removed. At the same time it proposes a threshold system starting at 1.4%, which will enable the institutions – the Council acting unanimously, Parliament by qualified majority – to monitor the growth of the Community's needs, so that new tranches of own resources could be granted only by full agreement of the institutions and the Member States.

8. The Commission is further proposing that as a transitional measure, until such time as Community policies and hence the Community Budget have been brought into better balance, there should be a diversification of resources which would contribute immediately to the reduction of the Community's budgetary problems. This would involve the application of a corrective mechanism to part of the revenue derived from VAT, to cover a significant portion of the Budget (calculated by reference to the volume of agricultural expenditure). One advantage of this modulation, calculated on the basis of the indicators set out in paragraph 14 below, is that a significant contribution could thus be made to the correction of imbalances in the Community without insuperable difficulties being raised for other Member States. It is against this background that the Commission would ask the Council and Parliament to appraise the ideas which it is laying before them.

9. The attached document is a draft Council Decision replacing the Council Decision of 21 April 1970 on the Communities' system of own resources. In submitting this to the Council and Parliament, the Commission recalls that in 1973 it presented a proposal for the revision of Article 201 of the Treaty of Rome which would have transferred full revenue-raising powers to the Community. The adoption of this proposal remains the Commission's long-term aim.

10. In making this proposal for extending the Community's resources, the Commission has sought to identify those forms of new revenue which best reflect the overall interest of the Community, which enhance the attraction for all Member States of full participation in Community policies and which best ensure a coherent relationship between the Community's revenues and its pattern of expenditure.

11. The Commission proceeds from the assumption that the existing range of own resources must remain intact. Customs duties and agricultural and sugar levies should continue to be paid automatically to the Community Budget. In addition, it is time to correct the anomaly whereby customs duties on products falling under the ECSC Treaty do not count as Community own resources. The Commission is therefore proposing their inclusion as General Budget revenues. The Commission considers its right that a certain percentage of the receipts from customs duties and agricultural levies should continue to be reimbursed to the Member States to cover cost of the services their administrations perform on the Community's behalf in collecting them. But a fixed level of reimbursement seems no longer justified. The commission therefore proposes that the figure, which must in no circumstances exceed 10%, should be decided by the budgetary authority.

12. The Commission maintains its view that value added tax should remain for the foreseeable future the cornerstone of the Community's financial autonomy. It therefore proposes that the ceiling of 1% currently applied to VAT should be removed and that the Community's budgetary authority should henceforth be empowered to raise VAT revenues in excess of this amount. In the Commission's view, however, the decision-making procedure in the budgetary process would have to be modified to take account of the removal of this ceiling. The Commission therefore proposes that increases in the VAT rate beyond 1.4% may only be authorized, in additional fractions of 0.4%, on a proposal from the Commission, by the budgetary authority, the Council acting unanimously, and the European Parliament by a majority of its Members and three-fifths of the votes cast. The Commission envisages that whenever a fraction of 0.4% is exceeded, the functioning of the Community's financing system could, if necessary, be reviewed. The Commission will on such occasions make any appropriate proposals.

13. For as long as agricultural expenditure accounts for a preponderant share of the Community's Budget, a diversification of resources is, in the Commission's view, required, so that they can match more closely the pattern of expenditure. The Commission proposes that this should be done by temporary application of a modulating factor (in the form of variable rates) to part of the VAT revenues assigned to the Community. The revenues from these variable rates would be equal to the difference between EAGGF Guarantee Section expenditure (less expenditure on food aid and expenditure in connection with the sugar protocol with the ACP states) and 33% of total Budget expenditure.

14. The variable VAT rates would be determined by reference to several indicators, first of all the share of each Member State in the Community's final agricultural production of products subject to common market organizations. This link would ensure more homogeneity be-

tween resources and expenditure in the present situation. Per capita gross domestic product would be a measure of different countries' relative levels of prosperity. To cover all relevant factors the Commission suggests using the average of indices calculated on the basis of market exchange rates and purchasing power parities. Lastly the Commission proposes using the index of each country's share in the Community's net operating surplus, an index which reflects the vitality of the different economies concerned.

For each of these indicators the Community possesses full statistics compiled on reliable bases and harmonized over many years.

15. Since the Community's objectives in the energy field, including energy research and development, are so essential, the Commission feels it right in present circumstances to propose a special effort to develop Community-wide policies aimed at achieving a more rational and economical use of energy and more secure and diverse supply. Conscious of the need to avoid proposing a new expenditure programme without giving thought to its financing, the Commission is considering the idea of introducing into the own resources system revenue from a tax on non-industrial consumption of energy. It will be submitting its package of energy proposals in the coming month.

16. Finally, Article 7 of the draft decision provides that any balance between income and expenditure at the end of the year may in future be retained by the Community.

DRAFT

Council Decision of on the Communities' system of own resources

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 201 thereof;

Having regard to the Treaty establishing the European Atomic Energy Community, and in particular Article 173 thereof;

Having regard to the proposal from the Commission;

Having regard to the Opinion of the European Parliament;

Having regard to the Opinion of the Economic and Social Committee;

Whereas the Council Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources, hereinafter referred to as "the Decision of 21 April 1970", introduced a Community system of own resources;

Whereas the own resources system should be diversified and extended while retaining the existing sources of revenue introduced by the Decision of 21 April 1970;

Whereas customs duties on products within the scope of the Treaty establishing the European Coal and Steel Community should be included in the Communities' own resources;

Whereas the 1% limit to the rate applied to the uniform basis for assessing value added tax, laid down in the Decision of 21 April 1970, should be abolished; whereas at the same time, in order to reinforce budgetary discipline, increases in the authorized rate of value added tax should be expressed in fractions of a percentage point;

Whereas, furthermore, for as long as guarantee expenditure in support of agricultural production exceeds a certain proportion of the Budget of the Communities, variable rates of value added tax should apply, taking into account certain economic indicators;

HAS LAID DOWN THESE PROVISIONS, WHICH IT RECOMMENDS TO THE MEMBER STATES FOR ADOPTION:

Article 1

The Budget of the Communities shall, irrespective of other revenue, be financed entirely from the Communities' own resources.

Article 2

Revenue from:

(a) Levies, premium, additional or compensatory amounts, additional amounts or factors and other duties established or to be established by the institutions of the communities in respect of trade with non-member countries within the framework of the common agricultural policy, and also contributions and other duties provided for within the framework of the organization of the markets in sugar;

(b) Common Customs Tariff duties and other duties established or to be established by the institutions of the Communities in respect of trade with non-member countries, including customs duties on products within the scope of the Treaty establishing the European Coal and Steel Community;

shall constitute own resources to be entered in the Budget of the Communities.

Article 3

1. Shall also constitute own resources, revenue accruing from the application of the value added tax to an assessment basis which is determined in a uniform manner for Member States according to Community rules, and obtained in accordance with the provisions of this Article.

2. Revenue shall be obtained by the application of a uniform rate of value added tax. Subject to paragraph 6, this rate shall be fixed within the framework of the budgetary procedure, taking into account all other receipts.

3. In addition, as long as expenditure under the European Agriculture Guarantee and Guidance Fund, Guarantee Section (less expenditure on food aid and expenditure under the sugar protocol with the ACP States) exceeds 33% of total expenditure, variable rates of value added tax shall apply. Such rates shall be fixed taking into account Member States' shares in the final agricultural production of products subject to common market organisations and in the net operating surplus of the Community and their gross domestic product per capita defined by the average of indices calculated on the basis of market exchange rates and purchasing power parity.

The revenue accruing from these variable rates shall be equal to the difference between the expenditure referred to above and 33% of total expenditure in the Budget.

In the event of exceptional and unexpected developments in Community expenditure, this threshold may be varied by the procedure provided for in Article 3(6).

4. If at the beginning of the financial year the Budget has not been adopted, any rate of value added tax previously fixed shall remain applicable until the entry into force of a new rate.

5. For the purposes of paragraph 6, an overall rate of value added tax shall be calculated from the sum of the uniform rate referred to in paragraph 2 and the weighted average of the variable rates referred to in paragraph 3.

6. A decision based on a proposal from the Commission shall be required before the overall rate of value added tax can exceed 1.4%. This decision shall be taken by the budgetary authority, the Council acting unanimously and Parliament acting by a majority of its members and three-fifths of the votes cast. Further decisions shall be required for subsequent increases, in fractions of 0.4% in the authorized rate.

Article 4

1. The revenue referred to in Articles 2 and 3 shall be used without distinction to finance all expenditure entered in the Budget of the Communities.

2. Financing expenditure connected with research programmes of the European Atomic Energy Community from the communities' own resources shall not exclude entry in the Budget of the Communities of expenditure relating to supplementary programmes nor the financing of such expenditure by means of financial contributions from Member States determined according to a special scale fixed pursuant to a decision of the Council acting unanimously.

Article 5

In order to cover expense incurred in collection, each Member State may be refunded up to 10% of the amounts of the own resources set out in Article 2. The rate applicable shall be fixed on a proposal from the Commission, by the budgetary authority, the Council acting unanimously and Parliament acting by a majority of its members and three-fifths of the votes cast.

Article 6

Any balance between the Communities' own resources and actual expenditure during a financial year shall be regulated in accordance with provisions to be adopted pursuant to Article 209 of the Treaty establishing the European Economic Community and Article 183 of the Treaty establishing the European Atomic Energy Community.

Article 7

1. The Community resources referred to in Articles 2 and 3 shall be collected by the Member States in accordance with national provisions imposed by law, regulation or administrative action, which shall, where necessary, be amended for that purpose. Member States shall make these resources available to the Commission.

2. Without prejudice to the auditing of accounts provided for in Article 206a of the Treaty establishing the European Economic Community, or to the inspection arrangements made pursuant to Article 209(c) of that Treaty, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, adopt provisions relating to the supervision of collection, the making available to the Commission, and the payment of the revenue referred to in Articles 2 and 3, and also the detailed rules for applying Article 3.

Article 8

Member States shall be notified of this decision by the Secretary-General of the Council of the European Communities; it shall be published in the Official Journal of the European Communities.

Member States shall notify the Secretary-General of the Council of the European Communities without delay of the completion of the procedures for the adoption of this Decision in accordance with their respective constitutional requirements.

This Decision shall enter into force on the first day of the month following receipt of the last of the notifications referred to in the second paragraph. At the same time the Decision of 21 April 1970 shall be repealed. To the extent necessary, any reference to the Decision of 21 April 1970 shall be understood as referring to the present Decision.

Done at For the Council

The President

Fiscal Austerity and Urban Innovation Project: International Dimensions

The Fiscal Austerity and Urban Innovation Project is currently surveying local officials in some 25 countries. Mayors, chief administrative officers, and council members are being surveyed about specific strategies they use to adapt to fiscal austerity. Strategies include better revenue forecasting, contracting out for certain services, user charges, performance indicators concerning local services. Some 33 such strategies are being explored to isolate distinctive innovations in their use of possible interest to local officials elsewhere.

The survey is being conducted by mail, phone, and personal interview depending on local circumstances. Conducting the survey are policy analysts in each country, usually persons who have conducted such studies for several years and have good contacts with local officials. Each national team is providing most of its own funding and administration of the survey.

The core of the study uses standard items to permit international comparisons. Case studies are being conducted of particularly interesting innovations and locales. Reports are prepared initially by teams collecting the data; more general results emerge from international comparisons. Coordination among the teams comes from a Project Newsletter, frequent conferences, and personal communication among participants.

Participating countries include: USA, Canada, Germany, France, UK, Ireland, Italy, Spain, Portugal, Norway, Denmark, Sweden, Finland, Belgium, Netherlands, Austria, Turkey, Israel, Yugoslavia, Japan, Pakistan, Philippines, Indonesia, Fiji, Korea, Nigeria, and Kenya. The Project began in September 1983 and continues to expand.

Copies of the Project Newsletter and further information are available from Terry Nichols Clark, 1126 E. 59 St., University of Chicago, Chicago, IL 60637, USA. Phone: 312-962-8686.

BANGLADESH: NEW DEVELOPMENTS

By K.A. Gofran

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A. BUDGET 1983-84 (EXTRACT)[1]

Turnover tax

As of this year, a new tax has been introduced under the name of turnover tax. The tax will be imposed on certain industry and business establishments like sweetmeat producers and dealers; auto-garages and workshops; shipyards and dockyards; steel furniture manufacturers and dealers; wooden furniture producers and dealers; wood treatment plants and saw mills; and printing presses will come under the scope of the tax. Those having less than 200,000 taka turnover will be exempt. Turnover tax will be levied at the rate of 2% on sale proceeds during the year. Establishments paying tax will obtain registration from the Excise Department and they may pay taxes on a self-assessment basis. The tax will be collected from 1 October 1983 after completing all necessary arrangements, including the drafting of rules. The additional revenue expected to be collected is 50,000,000 taka.

Income tax

Every year, certain amendments of the Income-tax Act are announced with the budget measures. It is then that the taxpayers come to know how their income of the year will be taxed. Under the Income-tax Law, assessment is made on the income of the *previous* year. Assessments for the year 1982-83, i.e. of the income of 1981-82, are made under the Law of 1982. The problem under this arrangement is that the taxpayers cannot prepare a proper budget of their income and expenditure and they do not have the opportunity to take full advantages of tax rebates. By changing this system, income tax amendments of 1983 will be effective from the assessment year 1984-85. Taxpayers may now plan their expenditure for the next year keeping in view the existing provisions of the Income-tax Act. As a transitional arrangement, assessments for the year 1983-84 for income year 1982-83 will be made under the provisions of the Income-tax Act as it existed in 1982. Only the rate of tax will be under the provisions of the Finance Ordinance, 1983.

See for a description of the Bangladesh tax system, *Taxes and Investment in Asia and the Pacific*, a publication of the International Bureau of Fiscal Documentation.

Under the existing Income-tax Act, various income items are not included in total income. There are also various deductions from total income. For an ordinary person, such calculation of income tax is very difficult. To simplify the procedure, arrangements have been made to abolish the list of various tax exemptions. But for legal reasons and in the interest of investors with a small income, some exemptions will continue to exist, i.e.:

(1) pensions and gratuities;
(2) dividends, interest from Government securities and approved debentures up to 5,000 taka;
(3) bank interest up to 3,000 taka;
(4) exemptions relating to income from new houses constructed up to 30 June 1985;
(5) existing income tax exemptions for diplomats; religious and charitable institutions, local authorities, foreign teachers and technicians.

At present, expenses for 3 purposes are exempted from payment of income tax. Donations to the Zakat Fund and national level sports organizations are fully exempt from income tax. Donations to educational institutions, hospitals, religious and charitable institutions are exempt up to 20% of total income. To encourage such charities, the latter exemption limit is now raised to 30%.

Under the existing provisions of the Income-tax Act, the opportunity to get a tax rebate through investments is limited. At present, a maximum amount of 35,000 taka can be invested for the purpose of the tax rebate. This limit has been withdrawn and provisions have been made to enable investment to benefit from the rebate up to one third of total income. The area of investment has also been widened. At present, an investment allowance up to 12,000 taka is admissible for investment in public limited companies. This limit is also withdrawn. However, investments will have to be made in public limited companies listed on the Stock Exchange. The opportunity for investment has also been widened by changing the definition of "cottage industry".

At present, capital gains are exempt from income tax if such gains are reinvested in new industrial undertakings. This condition is relaxed and the benefit is extended to investments in existing industries. To encourage the advancement of loans in the agricultural and rural sectors, overdue bank loans are exempted from income tax up to 1½% of the overdue loan.

The arrangement for collection of advance income tax from importers is withdrawn. Efforts will be made to collect advance income tax from persons engaged in the transport business, recruiting agents and travelling agents.

At present, income tax at the highest rate of 60% is charged on taxable income exceeding 160,000 taka. This rate will now be applicable to taxable income exceeding 200,000 taka.

At present, the maximum limit of income under the self-assessment scheme is 50,000 taka. This limit is raised to 75,000 taka.

1. The Budget Speech was pronounced on 30 June 1983.

Urban immovable property tax

At present, two types of taxes are imposed on the same urban property which are collected by the municipal authorities and the income tax authorities under different laws. To remove the difficulty of the taxpayers and to give the municipalities an opportunity to collect more taxes, the urban immovable property tax is abolished.

B. FINANCE ORDINANCE, 1983: SALIENT FEATURES

In the following paragraphs we will discuss the salient features of the Amendments brought about in the Income-tax Act 1922 by the Finance Ordinance 1983.

The amendments made to the Income-tax Act 1922 by the Finance Ordinance 1983 will come into effect from the Assessment year 1984-85 except the income tax rates. The income tax rates for the Assessment year 1983-84 have been given in the Finance Ordinance 1983 in section 11 as follows:

Rates of income tax

A. In the case of every individual, Hindu undivided family, unregistered firm, an association of persons and every artificial juridical person referred to in clause (9) of section 2 of the Income-tax Act 1922 (XI of 1922), not being a case to which paragraph B. applies.

Income (taka)	*Rates (taka + % on excess)*
below 10,000	2.5%
10,000 – 20,000	250 + 5%
20,000 – 30,000	750 + 10%
30,000 – 40,000	1,750 + 20%
40,000 – 50,000	3,750 + 30%
50,000 – 80,000	6,750 + 40%
80,000 – 130,000	18,750 + 50%
130,000 – 200,000	43,750 + 55%
over 200,000	82,250 + 60%

Provided that –

(i) no income tax shall be payable on a total income which before the deduction of the sums, if any, exempted under the first, third and, fourth provisos to sub-section (1) of section 7, section 15, section 15AA, section 15C, section 15CC, section 15D, section 15DD, section 15DDD, section 15F and section 58F of the Income-tax Act 1922 (XI of 1922), does not exceed 20,000 taka; and

(ii) the income tax payable shall in no case exceed –
  (a) the amount by which the total income exceeds 20,000 taka, or
  (b) the amount representing 60% of the total income, whichever amount is less.

Provided further that in the case of a person other than a company being resident and ordinarily resident in taxable territories bringing income accruing and arising outside taxable territories into Bangladesh through official channels, income tax shall be charged at the rate of 30% of such income or at the rate applicable to his total income including such income, whichever is more beneficial to him.

Explanation. The expression "taxable income", as used in this paragraph, means:

(a) in the case of an assessee to which sub-section (3) of section 11 of this Ordinance or clause (a) of sub-section (1) of section 17 of the Income-tax Act 1922 (XI of 1922), applies, the total income;

(b) in any other case, the total income of an assessee as diminished by the allowances admissible under the first, third and fourth provisos to sub-section (1) of section 7, section 15, section 15AA, section 15C, section 15CC, section 15D, section 15DD, section 15DDD, section 15F and section 58F of the Income-tax Act 1922 (XI of 1922).

B. In the case of every company and local authority and in every case in which under the provisions of the Income-tax Act 1922 (XI of 1922), income tax is to be charged at the maximum rate –

	Rates
(i) on the whole of the total income excluding the amount representing income from dividends from a company having its registered office in Bangladesh –	
(a) in the case of every industrial company	50% of such income
(b) in the case of all other companies including banks and financial institutions and local authorities.	60% of such income
(c) in the case of a person not being a company who is not resident in taxable territories	30% of such income

Provided that a rebate at the rate of 10% of the tax shall be allowed to a company registered in Bangladesh under the Companies Act 1913 (VII of 1913), on so much of its income, profits and gains accruing or arising outside the taxable territories to which sub-section (4) of section 11 of this Ordinance does not apply as are brought by it into Bangladesh.

	Rate
(ii) on the amount representing income from dividends declared and paid by a company formed and registered in Bangladesh under the Companies Act 1913 (VII of 1913), or a body corporate formed in pursuance of an Act of Parliament in respect of the share capital issued, subscribed and paid after August 1947	15%

C. In the case of every registered firm –

Income (taka)	*Rate (taka + % on excess)*
below 20,000	nil
20,000 – 30,000	0 + 10%
30,000 – 60,000	1,000 + 15%
60,000 – 110,000	5,500 + 20%
110,000 – 160,000	15,500 + 25%
over 160,000	28,000 + 30%

Provided that income tax shall not be payable by a registered firm in respect of the income, profits and gains derived by it from the exercise of a profession if such income, profits and gains depend wholly or mainly on the personal qualifications of its partners who are prevented by any law for the time being in force or by convention or rules or regulations of the professional association, society or similar body of which they are members to constitute themselves into a corporate body with a limited liability which can be registered as a company under the Companies Act 1913 (VII of 1913), unless such profession consists wholly or mainly in the making of contracts on behalf of other persons or the giving to other persons of advice of a commercial nature in connection with the making of contracts.

Explanation. The term "registered firm", as used in this paragraph, means a firm registered under section 26A of the Income-tax Act 1922 (XI of 1922), or a firm treated as a registered firm under clause (b) of sub-section (5) of section 23 of the Income-tax Act 1922 (XI of 1922).

1. Omission of section 4(3)

By omission of section 4(3) the incomes which were excluded from the computation of total income became taxable. However, by virtue of notification under section 60 of the Income-tax Act 1922, the N.B.R. has exempted many of such incomes in Gazette Notification 1/7/1983 by S.R.O. 241-L/83. Some of the exceptions are receipts of a casual non-recurring nature not exceeding 2,000 taka, income from non-professional writings, income from literary work of a creative nature and capital gains arising out of sale of share or stock of limited companies to the extent of 10,000 taka.

By omitting section 4(3) the Government was afraid that the matter had been oversimplified. The omission of section 4(3) as discussed above and insertion of some of them by notification in section 60 is not understandable.

2. Insertion of section 10(2)(xia)

By insertion of clause (xia) in section 10(2), banks giving agricultural or rural loans can now make provision for bad and doubtful debts for overdue loans, up to a maximum of 1½ times such overdue loans. By this amendment the discretion of the DCTs to allow bad debts for such bank loans has been taken away.

3. Amendment to section 12B(7)

By substituting the words "an industrial undertaking" for the words "a new industrial undertaking" (sub-section (7) of section 12B was inserted by Finance Ordinance 1982), an assessee is exempt from payment of capital gains arising out of the disposal of his capital assets if the gain is invested in acquisition of an industrial undertaking.

We feel that this is a good amendment which will encourage taxpayers to buy disinvested business enterprises by selling their otherwise idle capital assets.

4. Amendment to section 14(3)(b)(ii)

The explanation inserted by the Finance Act 1980 as further amended by the Finance Ordinance 1982 was amended by Finance Ordinance 1983. By amendment in 1982, capital invested in an industry deemed a "cottage industry" must among other things not exceed 50,000 taka. The investment of the amount of 50,000 taka has been confined to plant, machinery and equipments by the Finance Ordinance 1983. It is hoped that this amendment will give the cottage industry a broader base.

5. Amendment to section 15(3)

By this amendment the maximum investment has been extended up to one third of the total income of the assessee irrespective of any monetary limit.

It is hoped that this amendment will encourage investment.

6. Amendments to section 15AA & section 15C

By certain amendments to the two sections the exemption in respect of investments in bonds was extended and investments in respect of acquisition of any stocks or shares were limited to acquisition of shares, etc. of a public company as defined in the Companies Act 1913 and listed on a Stock Exchange. Therefore, acquisition of shares by many non-company assessees of public companies which are not listed on a Stock Exchange will not rank for investment allowance from the assessment year 1984-85. This is intended to develop the capital market.

7. Amendment to section 15D(2)

Restriction of the exemption in respect of donations to 15D approved institutions has been extended up to 30% of the total income of an assessee (was 20%). This amendment may encourage donations to 15D approved institutions. We welcome this amendment.

8. Amendment to section 15F

The investment in respect of purchase of books (subject to total allowable investment) has been restricted to 3,000 taka.

This restriction is discouraging for the purchase of books by professional authors, advocates, lawyers and the general public. We feel that in the days of rising prices of books this restriction should not have been introduced.

9. Amendment to section 16(1)(A)

By this amendment a donation given to 15DDD approved sports organizations became includible in total income. This amendment is of no consequential nature since 15DDD was inserted a few months ago.

10. Amendment to section 18(3BB)

By this amendment provision for collection of tax by any person for any prescribed purpose is made. From the language of the amendment it appears that provision for a new income tax rule has been made. Unless that rule is made we cannot comment on this.

The Finance Ordinance 1983 repealed the Urban Immovable Property Tax Act 1957 (E.D. Act X1 of 1957). We welcome this withdrawal of tax. This tax in some way was being collected by the municipalities and resulted in a kind of double taxation. There have been no amendments to the Gift-tax Act and Wealth-tax Act by the Finance Ordinance 1983.

By publishing a draft amendment in Rule 45A (Gazette of July 1982, S.R.O. 243-L/83), the N.B.R. has elicited public opinion to raise the limit of self-assessment from the current 50,000 taka to 75,000 taka. We hope that the limit of 75,000 taka would encourage declaration of new and also true income.

BANGLADESH:

Budget 1983-84

Budget Speech pronounced on 30 June 1983 by Mr. A.M.A. Muhith, Minister of Finance and Planning.

FISCAL MEASURES

While outlining the fiscal measures for the coming financial year I would like to emphasize that our development process cannot be speeded up without increased mobilisation of internal resources. While efforts are to be made to increase tax revenues, conditions have to be created at the same time which not only promote investment but also bring about an improvement in the standard of living of the people. The attainment of these apparently contradictory objectives may be difficult to achieve. However, with this end in view, a continuous review of the fiscal policy and tax measures was carried out throughout the year. On this issue, meetings were also held by the Consultative Committee for Mobilisation of Internal Resources. Besides this, proposals and suggestions were received from individuals and organisations. The fiscal policy and measures for tax revenues presented by me represent the end-product of detailed analysis and dialogue carried over a whole year. I do not claim that all the reasonable proposals received this year have been incorporated in the Budget, but I can assure you that all the proposals received have been duly considered.

2. The basic principles in formulating proposals for the fiscal measures of the Government remain the same as those of last year. However, restating these may not be out of place.

- To provide relief to the poor from the burden of taxes.
- To help the domestic industries to expand and to augment the production process.
- To bring rationality and equity in tax administration.
- To simplify the method of tax collection by making it easy, rational and comprehensible to the common taxpayers.
- To bring more taxpayers under the tax net.
- To use tax policy to encourage exports and check imports.
- To integrate metric system in revenue accounts.
- To bring dynamism in tax collection by charging duties at ad valorem instead of specific rates.

Import duties

3. The objectives in designing customs duties have been to continue the efforts to strengthen internal production processes, to provide new opportunities for industrialisation, to discourage use of luxury goods, to ensure supply of essential necessities for the common consumers, to harmonize and simplify customs tariff structure, to simplify tariff rates so as to facilitate quicker assessment and release of imported goods and to modernize application of customs tariff. In addition, we have tried to bring about certain structural changes in the tariff rating this year as detailed below:

4. Imported items are mainly of three types, viz, basic raw materials, processed raw materials and intermediate goods used as industrial inputs and finished goods. Among the intermediate goods which are imported into the country, some are used as input in local industrial processes, some find use both as input and finished products. Some imported finished items are essential in nature and there is no other alternative but to import these items to meet the requirement of the country. The demand for some other items is small and can be met by minimal import. Some other items are imported for specific selective purposes and to meet high quality needs. Considering all relevant aspects, seven slabs of duty rates have been adopted. Earlier, it was twenty-three slabs of duty rates which were reduced to twelve in last year's budget. Further reduction of duty slabs this year has been done on the basis of a well considered principle involving correct categorisation of imported items. We have been able to categorise two thousand imported items in accordance with this procedure. We hope to complete categorisation of remaining items in future. The Chief Martial Law Administrator has appointed a Committee to review and simplify existing customs procedure and organisational set-up. This Committee will, inter alia, finalise the work of categorisation of imported items.

5. Import duty on basic raw materials has been fixed at 20%. Import duty on processed raw material like billet and items which are partly manufactured but imported for use in local industries like button blanks have been fixed at 50%. Fully processed items which have use both as raw materials and finished product like components of watch and clock have been dutied at 100%. Depending on consumption pattern, duty on import finished products has been spread over four slabs, viz, 100% (telephone set) 150% (stainless steel blade), 200% (fents), 300% (knit fabrics) and 400% (superior brands of cigarettes). It is, however, necessary to mention that, some special concessionary rate like 2½% for imported machinery for installation in less developed areas, 5% for cement, clinker and baby food, 10% for cotton, wool tops and synthetic tops and 15% for imported machineries for installation in developed areas have been retained.

6. While carrying out categorisation of items and fitting them into seven slabs, all items falling under 40% duty slab have generally been fixed at 50% while all items falling under 75% duty slab have been fixed at 100%. Considering special aspects, in some cases, duty slab has been merged with a lower instead of the higher slab. For example, duty on CKD jeep or CKD 850 c.c. car have been reduced to 20% from 40% while duty on spices, nylon filament yarn, glass fibre, waxes, tyres and tubes of buses and trucks have been reduced to 50% instead of being fixed at higher levels.

7. A new measure has been introduced in the shape of repayment of customs duty to local industries. This is based on full utilisation of imported intermediate and finished goods as inputs by domestic industry. Steps have also been taken to make the repayment procedure simple and expeditious. Repayment of duty paid in excess of 50% has been provided for in case of use of vulcanised sheet required by silver can manufacturing industry. Cellulose and acetate sheet used in manufacture of spectacles frame and raw materials imported for use in paint industries. Repayment of duty paid in excess of 15% on materials used in manufacture of transformers has been arranged. Repayment of full customs duty paid on import of polythene pellets, imported by the fertilizer factories, have been provided for. These measures have been adopted as these inputs have alternate uses.

8. Some items of similar nature have been brought under uniform rate of duty. This will reduce scope for application of discretion and reasons for complaint. Prepared paints and lacquers have been brought under 150% duty slab. Scientific equipment is assessed under different rates. It has now been brought under 20% and 50% duty rates.

9. In order to modernise account keeping system in the country and also to encourage use of modern equipment in administrative and research organisations, present duty rate at 50%, 100% and 300% levied on computer, cash register and magnetic tapes respectively have been reduced and brought down to 20%. Sales tax has been completely exempted on these items. At the same time, duty on calculating machine has been reduced from 100% to 50%. Duty on photographic film, plate, and chemicals has been reduced from 100% to 50%.

10. A clear-cut policy has been adopted in respect of fixation of tariff value. Tariff value will be reviewed twice in a year and the value will be fixed keeping in view international prices. However, considerations, such as promotion of domestic industry, easing or restricting imports, will continue to guide fixation of tariff value.

11. Raw materials used in the pharmaceutical industry are now dutied at 10% and 25%. The new Drug policy will render the use a large number of raw materials of the pharmaceutical industry unnecessary. On the other hand, a scrutiny of the list of pharmaceutical raw materials reveals that many of the items have alternative uses. After a review of the situation, a new list has been prepared. Provision of repayment of duty in excess of 20% has been provided for. This facility shall also be available for recognised Unani and Ayurvedic system of medicinal manufacturers.

12. The measures enumerated above should yield a net revenue gain of Taka 20 crores. Last year, collection of revenue increased substantially due to tariff slab and duty rate adjustments. It is expected that the same trend will continue this year.

Export duty

13. Most of the export duties were withdrawn in the last year's budget. Export duty was fixed on wet blue leather only at 5%. It was expected that exporters would thereafter concentrate on export of finished leather. These hopes did not materialise. Now, export duty at 10% rate is imposed on wet blue leather. However, exporters of finished leather who will export more than 20% of finished leather or leather goods over last year's export will pay 5% duty on export of wet blue leather and those who will export 50% or more of finished leather and leather goods will pay 2½% duty on export of wet blue leather.

14. This measure will generate an additional revenue of Taka one crore.

Sales Tax

15. Sales tax is realised only on imported items since last year. Some items are exempted from sales tax. This year sales tax exemption is allowed to staple fibre, computer, cash register and magnetic tape. Considering that customs duty on machinery spares has been increased from 40% to 50%; sales tax levied at 10% on these items is withdrawn. As a result of this adjustment, total tax incidence on machinery spares shall be a little less. Sales tax levied on nylon chips is reduced from 20% to 10%.

16. Sales tax at 10% is imposed on fresh fruits and ships imported for breaking. However, special exemption to import of fresh fruit imported during Ramzan will remain in force.

17. Sales tax has been imposed at 20% on certain items as a measure of protection to local industries and in some instances, for health reasons. These are tobacco and tobacco products, cummin seeds, dry chillies, corriander seeds, garlic and ginger, sugar and cereals and flour made out of cereals. Partial exemption of sales tax allowed on tarpaulin, simplex board and cigarette paper are withdrawn, thereby rendering the items to levy of sales tax at 20%. Domestic insecticide aerosol spray is also levied to sales tax at 20%. Sales tax on cigarette paper will be increased from 10% to 20%.

18. These measures will result in slight fall in sales tax revenue. In fact, the abolition of sales tax on indigenous products last year has led to a proportionate reduction in revenue receipts from sales tax.

Excise Duty

19. With the progress of industrialization in the country, the collection of excise duty will increase continuously. However, the system of collection of excise duty remains traditional. At present, manufactured goods are cleared in the presence of excise officials in the mills and factories. Industrialists do not object that much to pay excise duty but they do not like the presence of excise officials. The more industrial units will continue to grow, the more difficult it will be to post government officials in factories. We are going to change this procedure altogether and introduce the system of self-clearance of manufactured goods. Industrialists will render account themselves and pay duty accordingly. Of course, appropriate measures will be taken to check evasion of duty. Use of raw materials, energy consumption, wage bill, account of export consignments or packaging materials and such other matters will be examined and tallied to check evasion of excise duty. For this, the administrative structure of the excise department will have to be recast completely and yardsticks for measuring production will have to be determined. Repayment system of customs duty will deter evasion of excise duty to some extent.

20. This new system will be introduced in the first stage on 1st of January, 1984. The items which will come under the self-clearance system at that time are cotton yarn and fabrics, fabrics made from man-made yarn, jute manufactures, soaps, detergents, paper, packaging materials, china and porcelainwares, POL products, PVC pipe, rexine cloth, tea, plastic foam, insulation board, telephone set, rubber belt, rubber pipe, tyre and tube, rubber foam, soft drinks, metal containers, electric bulb and flourescent tube, electric fan, radio and television set, wires and cables, and transport vehicles including two-wheelers. In the second stage, on 1st May, 1984, another seven items will come under the self-clearance scheme. These seven items are – glass and glasswares, paper board, electric battery, footwear, M.S. products, paints, pigments and varnishes, and perfumery, cosmetics and toilet preparations. This year, sugar, glucose and dextrose, cement, asphalt, starch, medicine and medicinal products, antiseptic, disinfectant, insecticide, pesticide and germicide, stainless steel, welding electrodes and oxygen, carbon-dioxide, nitrous oxide gas and acetylene were brought under self-assessment scheme. With this, the traditional system will remain in operation only for cigarette, biscuit, bread and matches and self-clearance system will be introduced for all the rest of the items.

21. In case of cotton yarn and fabric manufacturing, complications in collection of duty have increased owing to existence of different rates of duty. For cotton yarn, there are five rates including exemption. Merging these rates, duty has been fixed at the rate of one taka and fifty poisha per kilogram of cotton yarn made in textitle mills. Presently there is one rate for cotton fabrics and another for fabrics of man-made fibres. Again, different duty rates are prevalent for cotton fabrics made out of imported cotton and local cotton. Besides, for different types of fabrics there are different duty rates. Duty at the rate of 35 poisha per square metre has been fixed for all types of fabrics produced in mills merging all the rates into one. To help improve standard of quality of fabrics all duty rates now applicable for mechanical processing have been exempted. No duty has to be paid now for processing, such as, calendering, mercerising, etc. Besides, to reduce the gap between duty payable under normal system and under the optional payment of fixed monthly duty under '96KK' of excise rules on power looms, duty is fixed at taka two hundred in place of taka one hundred and sixty-five. In case of Warpknitting machine taka one thousand is refixed in place of taka eight hundred and thirty.

22. The existing duty rate on mechanically produced biscuits is 15% of the retail price. Excise duty on mechanically produced biscuits has been reduced to 10% of retail price keeping in view the purchasing power of the common buyers. Simultaneously, excise duty at the rate of 10% of retail price has been imposed on mechanically produced bread. As a result the chance of evasion of duty of mechanised backery will be substantially eliminated.

23. To increase demand by reducing price of goods produced in the country, the duty rates of the following items have been brought down:

Duty rate on jute carpets has been reduced to 25% in place of the existing 35%;

Duty rate on jeeps assembled in the country has been brought down to 5% in place of the existing 10%;

Duty rate on wires and cables has been reduced to 20% in place of the existing 25%.

24. To promote production, duty on stainless steel cutleries and crockeries and steel furniture has been completely withdrawn. Besides, the temporary exemption on glazed potteries has been extended up to 30th June, 1984. Excise duty on performances, such as, jatra, theatre, circus, magic show, puppet show, etc. (except cinema), has been completely withdrawn.

25. To encourage tourism industry, certain changes are being brought about in the calculation of excise duty on hotels and restaurants. Duty will be collected only on room rent and food including drinks. For charges, such as, service charge, laundry charge or telephone charge no exercise duty will have to be paid.

26. In case of colour television, there will be three duty slabs in place of the present two slabs:

On screen size not exceeding 14 inches Taka 1200.

On screen size between 14 inches to 20 inches Taka 2000.

On screen size exceeding 20 inches Taka 3000.

27. The definition of "cottage industry" has been further modified this year also. An industry where only machinery and equipment are valued up to taka 50,000 will be recognised as cottage industry. By this measure, more industrial concerns will get exemption on account of excise duty as well as income-tax.

28. In some specific cases, arrangement has been made to collect new excise duty. These items will come under the purview of self-clearance system from the beginning.

(a) Excise duty at the rate of 10% is imposed on overseas telephone and telex services.
(b) Excise duty at the rate of 10% is imposed on particle board, hard board and plywood. No excise duty will be leviable in case of plywood used in tea chest.
(c) Excise duty is imposed at the rate of 5% on the retail price of allopathic, Homeopathic and Unani systems of medicine. Temporary exemption was granted on allopathic medicine last year for special reasons.
(d) I have already spoken of the increase in duty rate of natural gas. Duty rate has been increased from taka seventeen and fifty poisha to taka twenty one and sixty-five poisha per thousand cubic feet. In case of gas used in the production of elec-

tricity and fertilizer, the duty rate will be taka nine and fifty poisha. The duty rate will amount to taka seven hundred and sixty five and taka three hundred and thirty five calculating per thousand cubic metre.

29. I spoke of a new system of collection of entertainment tax on cinema houses last year. Following consultations with all concerned, we are going to introduce a new system now. Under the new system, there will be no excise stamps and no necessity of supervision of cinema halls by the excise department. The rate of payment of duty per seat will remain unchanged. But there will be no need to render account of sale of ticket. Duty will be collected on a fixed percentage of the duty payable on the full utilization of the number of seats in the hall. This duty will be paid by the owners of the cinema halls in advance for every fifteen days. This system will come into effect on the first day of August next. The capacity utilisation rate on which entertainment tax will be paid are:

(a)	For airconditioned cinema halls in the metropolitan area of Dhaka.	65%
(b)	For airconditioned cinema halls in the metropolitan area of Chittagong.	55%
(c)	For other cinema halls of Dhaka and Chittagong metropolitan areas.	45%
(d)	For all cinema halls of Khulna Rajshahi towns.	35%
(e)	For all cinema halls of district towns.	30%
(f)	For all cinema halls of subdivisional towns and municipal areas.	20%
(g)	For other areas.	5%

30. For new imposition of excise duty taka twenty crores will be collected.

Turnover tax

31. I proposed imposition of this new tax last year. However, in the absence of definite signs of overcoming the economic recession, this tax was not imposed finally. This tax will be imposed this year on some industry and business establishments. Sweetmeat producers and dealers, auto-garages and workshop, shipyard and dockyard, steel furniture manufacturers and dealers, wooden furniture producers and dealers, wood treatment plant and saw mill and printing press will come under the purview of this tax. Those having less than two lakh taka turnover will be exempted from payment of the tax. Turnover tax at the rate of 2% will have to be paid on sale proceeds during the year. Establishments paying tax will obtain registration from excise department and they may pay taxes on self-assessment basis. This tax will be collected from 1st October, 1983 after completing all necessary arrangements, including rule making. Taka five crores is expected as revenue on this account next year.

32. One Deputy Controller from narcotics and liquor department has been posted in each divisional headquarter. Under the circumstance, Deputy Controller of Narcotics and Liquor will perform the work of this Department in place of the Deputy Commissioner of districts.

Income tax

33. In the field of income tax, efforts have been made to achieve two broad objectives next year. The first one is to simplify income tax computations so that taxpayers would comprehend these more easily. The second objective is to encourage investment. In our efforts to revise the income tax law to suit the needs of the changing time, we have received encouragement and support from all quarters. As for the new Income tax Law, I believe it should be possible to promulgate it at the beginning of 1984. There just was not sufficient time this year.

34. Every year, certain amendments of the Income tax Act are announced with the budget measures. The taxpayers come to know how their income of the year will be taxed after the budget announcements. Under the income tax law, assessment is made on the income of the previous year. Assessment for the year 1982-83 i.e., of the income of 1981-82 is made under the law of 1982. Problem under this arrangement is that taxpayers cannot prepare a proper budget of their income and expenditure and they do not get the opportunity to take full advantage of tax rebates. By changing this system, income tax amendments of 1983 will be effective from the assessment year 1984-85. Taxpayers may now plan their expenditure for the next year keeping in view the existing provisions of the Income tax Act. As a transitional arrangement, assessment for the year 1983-84 for income year 1982-83 will be made under the provisions of the Income tax Act as it existed in 1982. Only the rate of tax will be under the provisions of the Finance Ordinance, 1983.

35. Under the existing Income tax Law, various incomes are kept out of the total income. Again, there is scope for various deductions from the total income. For an ordinary person, such calculation of income tax is very difficult. To simplify the procedure, arrangements have been made to withdraw the list of various tax exemptions. But for legal reasons and in the interest of investors of limited income, some exemptions cannot be withdrawn. Therefore, except a few items, all other income will now be included in the total income. The exemptions that will continue to exist are:

(1) Pension and gratuity.
(2) Dividend, interest from Government Securities and approved debentures up to Tk. 5,000.
(3) Interest from Bank up to Tk. 3,000.
(4) Provisions of exemption relating to income from new houses constructed up to 30th June, 1985.
(5) Existing income tax exemption of the diplomats, religious and charitable institutions, local authorities, foreign teachers and technicians.

36. At present expenditure for three purposes are exempted from payment of income tax. Donation to Zakat Fund and national level sports organisations are exempted from income tax. Donations to educational institutions, hospitals, religious and charitable institutions are exempted from income tax subject to the limit of 20% of total income. To encourage such charities the exemption limit is raised to 30%.

I should also mention here that exemptions notified under section 60 of the Income tax Act from time to time, like income from Post Office Savings Bank, will continue.

37. Under the existing provisions of the Income tax Law, opportunity to get tax rebate through investments is limited. At present, a maximum amount Tk. 35,000 can be invested for the purpose of tax rebate. This limit has been withdrawn and provisions have been made to enable investment up to one-third of total income. The area of investment has also been widened. At present, investment allowance up to Tk. 12,000 is admissible for investment in Public Limited Companies. This limit is also withdrawn. However, investments will have to be made in Public Limited Companies listed in the Stock Exchange. Opportunity for investment has also been widened by changing the definition of "cottage industry". At present capital gain is exempted from income tax if such gain is reinvested in new industrial undertaking. This condition is relaxed and the benefit is extended to investments in existing industries also. To encourage advancement of loans in the agricultural and rural sectors, overdue bank loans on this account is exempted from income tax up to 1½% of the overdue loan.

38. The arrangement for collection of advance income tax from the importers is withdrawn. Effort will be made to collect advance income tax from persons engaged in transport business, recruiting agents and travelling agents.

39. At present income tax at the highest rate of 60% is charged on taxable income exceeding Tk. 1,60,000. This rate will now be applicable on taxable income exceeding Tk. 2,00,000.

40. At present, maximum limit of income under the self-assessment scheme is Tk. 50,000. This limit is raised to Tk. 75,000.

Urban immovable property tax

41. At present, two types of taxes are imposed on the same urban property. The municipal authorities and the income tax authorities collect these taxes under different laws. To remove the difficulty of the taxpayers and to give the municipalities an opportunity to collect more taxes, urban immovable property tax is withdrawn.

42. Receipts under income tax and other direct taxes have been estimated at Tk. 310 crore for the next year.

Electricity duty

43. Duty at the rate of one paisa per unit of electricity consumption was imposed on the first of December, 1974. After a period of about ten years, the rate of this duty is raised to 5 paisa. This will generate a total revenue of about 5 crore taka.

44. The enclosed abstract contains information on the various proposals and also revenue effects of fiscal measures, wherever necessary.

Dear Fellow Citizens

45. I apologise for making a rather lengthy speech. I just wanted to tell you how far the Government was able to redeem the commitments made last year. I have made detailed statement on revenue raising and expenditure and development budget. Apart from these, this is for the first time that I got an opportun-

ity to discuss the annual policy and programme on money supply and bank credit. I have thus made an attempt to present before you an account of the economic and financial state of affairs of the country. I gratefully acknowledge the assistance I got from my colleagues and co-workers. I also respectfully thank the Chief Martial Law Administrator, who despite his many pressing commitments, spared valuable time over the year and encouraged and supported me in my task. Given the discipline we have achieved in economic management, it should no longer be impossible for us to achieve growth with stability although the process will take time.

IFA NEWS

Some Highlights from the Secretary General's 1982-1983 Report Presented at the Venice Congress 1983

MONTREAL CONGRESS

The 36th Congress of IFA took place in Montreal in the Queen Elizabeth Hotel under the supervision of Mr. Charles Albert Poissant assisted by Mr. Maurice Regnier (President of the Canadian Branch) and Mr. Giles Gagné (Treasurer of the Canadian Branch).

With respect to Subject I – "The tax treatment of interest in international economic transactions" – Mr. R.M. Hammer (U.S.A.) acted as discussion leader and Prof. E. Höhn (Switzerland) as General Reporter. Panelists on Subject I were Messrs. Rebizo (Argentina), Davies (United Kingdom) and Helmers (Sweden) and Mrs. Hogberg (France).

With respect to Subject II – "Taxation of payments to non-residents in international transactions" – it was Prof. I. Claeys Boúúaert (Belgium) who was the discussion leader and Mr. Gérard Coulombe (Canada) the General Reporter. Panelists on this subject were Messrs. Koch-Nielsen (Denmark), Abad (Spain), Herring (Australia) and Tavolaro (Brazil).

Chairman of the Seminar on "Imputation systems – Objectives and consequences" was Mr. D.A. Ward (Canada). Prof. Ault (U.S.A.) acted as Secretary. Background papers for this Seminar were submitted by Messrs. Buelinckx (Belgium), Poddar (Canada), Fontaneau (France), Franken (Fed. Rep. of Germany), Mayr (Italy) and Avery Jones (United Kingdom). Panelists were Messrs. Buelinckx, Short (Canada), Fontaneau, Mayr, Den Boer (Netherlands), Wright (United Kingdom) and Tillinghast (U.S.A.)

MITCHELL B. CARROLL PRIZE

No price was awarded in 1982-83.

IFA OFFICERS COME AND GO

IFA regretfully announces the passing away of the former Chairman of the Permanent Scientific Committee, Mr. J. Desmyttère (France). The U.S. Branch has nominated Mr. D.R. Tillinghast to join Prof. S.S. Surrey as a member of the PSC for the period of the preparation of the 1986 Congress to be held in the United States.

The Executive Committee met in Spring and welcomed 4 new members: Prof. P. Adonnino (Italy), W.H. Bratby (Australia), D.F.A. Davidson (United Kingdom) and Prof. A. Nooteboom (Netherlands). Mr. R. Caraza Escobedo (Mexico) will be due for statutory retirement.

NATIONAL BRANCHES

Two new Branches were recognized during the Montreal Congress, i.e. those of India and Sri Lanka. Branches are being created in Venezuela, Paraguay and Korea.

IFA now has more than 6,300 members and will have almost 40 national Branches in the near future.

The Secretary-General urges the Secretaries of the national branches to send as much information as possible on branch seminars (and working papers if any), joint meetings with other branches, etc. which would be of interest to branches of other countries. The IFA News column in the *Bulletin for international fiscal documentation* is available as a vehicle for the exchange of information between IFA branches and he feels that it is vital that this opportunity be taken. Regularly informing the other branches will supplement the work of the congresses which can necessarily only be held once a year.

MEMBERSHIP FEES

For the year 1982-83 the annual contribution was:

- US$ 38 for individual members of national IFA Branches;
- US$ 40 for direct individual members of IFA;
- US$ 90 for corporate members, both direct and of national Branches.

VENICE CONGRESS

At the time of writing the 1982-83 Report, the preparations for the Venice Congress were nearing completion. The President of the 1983 IFA Congress will be Prof. B. Visentini whereas Prof. A. Fantozzi and Prof. Adonnino will take care of its organization.

General Reporters are Prof. V. Uckmar (Italy) and Prof. DDr. H.G. Ruppe (Austria) for Subjects I (Tax avoidance/tax evasion) and II (International problems in the field of general taxes on sales of goods and services). Discussion leaders will be Prof. J. van Hoorn (Netherlands) and Prof. P. Sibille (Belgium). The Chairmen of the Resolutions Committees are Prof. Fontaneau and Prof. Helmers (Sweden). Prof. Claeys Boúúaert will chair Seminar A dealing with "Tax policy towards the national heritage". Panelists will be Prof. Visentini, Dr. G. de Ulhôa Canto (Brazil), Mr. Lainé (France), Mr. Kleeberg (Fed. Rep. of Germany) and Mr. Stanley (United Kingdom). Seminar B will treat "Tax aspects of foreign investments in Italy" and will be held in 4 language groups.

FUTURE CONGRESSES

1. *Buenos Aires Congress 1984*

The subjects which have now been determined are:

Subject I: Fiscal obstacles to the international flow of capital between a parent and its subsidiary (General Reporter: Prof. Dr. K. Vogel, Fed.Rep. of Germany).

Subject II: Social security contributions as a fiscal burden on enterprises engaged in international services (General Reporters: Prof. Dr. J.A. Macón and Prof. Dr. E.J. Reig, Argentina).

2. *London Congress 1985*

The subjects selected for the London Congress are:
Subject I: Problems concerning the assessment and collection of tax from non-residents.
Subject II: International taxation of inheritances and gifts.

Resolutions Venice Congress 1983

RESULTS OF DISCUSSIONS

At the end of the 37th IFA Congress in Venice (10-14 October 1983) the following resolutions were adopted. Note that both resolutions were originally drafted in the English language. Translations will be provided in French, German and Spanish.

SUBJECT I:
Tax avoidance/Tax evasion

RESOLUTION (original version)

The Congress,

FINDING THAT:

it is a fundamental right of the taxpayer to arrange his affairs so as to minimise his overall exposure to taxation within the law; and

CONSIDERING THAT:

(a) increasing tax pressures induce taxpayers to try to minimise their tax burdens;
(b) governments are concerned to prevent tax evasion and to eliminate tax avoidance

RECOMMENDS THAT:

Legislation should be drafted so as to ensure that:

1. the intent of the legislator is expressed in clear terms.
2. tax offences are clearly defined and provide for different sanctions between offences of a merely administrative nature and offences that may be considered fraudulent;
3. tax avoidance is not illegal;
4. obstacles do not impede the free movement of taxpayers, goods and services between jurisdictions;
5. anti-tax avoidance legislation has no retrospective effect;
6. taxpayers and their advisors are not exposed to penalties unless guilty of tax evasion; and
7. the onus of proof does not fall upon the taxpayers.

SUBJECT II:
International problems in the field of general taxes on sales of goods and services

RESOLUTION (original version)

CONSIDERING:

1. The worldwide use of general consumption taxes on sales of goods and services, the growing volume of international trade, and the increasing contacts of traders with foreign tax jurisdictions;

2. GATT Article III "NATIONAL TREATMENT ON INTERNAL TAXATION AND REGULATION", which sets forth the principle of equal treatment of imported and domestic goods, and the importance of applying this principle to all kinds of goods and services; and
3. The widespread acceptance of the territoriality principle combined with the destination principle in the field of general consumption taxes;

NOW IFA PROPOSES:

I. That national legislation on consumption taxes should implement these principles in a manner which ensures that double taxation and distortion of competition do not occur.

II. That countries should adopt appropriate measures to avoid any consumption tax burden on exports of goods and services, which result can be achieved most easily by a VAT or a retail sales tax system. These systems also more easily achieve the elimination of hidden tax burdens on imports and sales within the territory.

III. That even in a VAT or retail sales tax system, provisions in national legislation should be eliminated which impose an implicit tax (taxe occulte) on sales of goods or services. Input tax deduction in VAT systems is a fundamental requirement and should be based on the use of goods and services for business purposes unless this input is attributable to exempted output and personal transactions; but these should be restricted as much as possible.

IV. That, in order to avoid double taxation, international organisations should undertake the difficult but highly desirable tasks of developing:
   a. harmonised concepts concerning the territorial attribution of different types of transactions (especially in the field of services), and
   b. commonly accepted definitions of terms used in general consumption taxes, such as "goods", "services" and "business".

   In the meantime countries should minimise differences in such concepts and definitions by bilateral actions.

V. That in the application of general consumption taxes, foreign businesses should be treated in the same way as domestic businesses, both in legislation and administratively.

Conference Diary

DECEMBER 1983

Business Research International: Disclosure to the tax authorities at home and abroad. London (United Kingdom), December 1 and 2 (English).

British Branch of I.F.A.: Overseas tax developments (Tax Workshop). London (United Kingdom), December 6 (English).

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Business Research International, 57/61 Mortimer Street, London, W1N 7TD (United Kingdom).

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

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To facilitate ordering, a list of addresses of the main publishing houses is included on pages 47 and 48 of the January 1983 issue. See also Erratum (p. 193 of the May 1983 issue). Addresses of publishers which do not appear in this list are indicated in the item concerned.

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Jap Kim Siong:

Taxation in the Asian-Pacific Region
A country by country survey

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2 Nassim Road, Singapore 1025
Telephone: 235-1959 – Telex: RS50257 APTIRC
1983
144 pages
Price S$ 60

This is the first volume in what is hoped will be a long series of publications of the Asian-Pacific Tax and Investment Research Centre in Singapore. The survey was prepared on behalf of the Asian-Pacific Tax and Investment Research Centre and is based on the 8-volume loose-leaf work *Taxes and Investment in Asia and the Pacific* published by the International Bureau of Fiscal Documentation, Amsterdam, the Netherlands.

The present survey is offered as a general orientation to the tax system in each country situated in the Asian-Pacific Region. The countries and territories covered comprise Afghanistan, American Samoa, Australia, Bangladesh, Brunei, China (People's Republic), Cook Islands, Fiji, French Polynesia, Guam, Hong Kong, India, Indonesia, Iran, Japan, Korea (Republic), Macau, Malaysia, Nepal, New Caledonia, New Zealand, Pakistan, Papua New Guinea, Philippines, Singapore, Solomon Islands, Sri Lanka, Taiwan, Thailand, Trust Territory (including the Federated States of Micronesia, Palau Republic, the Marshall Islands and the Commonwealth of the Northern Mariana Islands), Western Samoa. In this respect it covers more countries and territories than *Taxes and Investment in Asia and the Pacific* at present, and is the only survey ever published in one volume on the region. The countries on which little literature is available in English have been dealt with more extensively than those countries on which more publications in English are available, e.g. Australia, Hong Kong, India, New Zealand, Philippines, Singapore etc.

The former include Afghanistan, American Samoa, China (People's Republic), Fiji, Guam, Indonesia, Iran, Japan, Korea (Republic), Macau, Nepal, New Caledonia, Papua New Guinea, French Polynesia, Taiwan (Republic of China), Thailand, Trust Territory of the Pacific Islands.

The survey per country follows a common outline to provide some basis for comparison except that on China (People's Republic), in view of the difference with respect to political philosophy concerning public ownership. The outline comprises classification of taxes and levies; an outline of taxes (corporate income tax, individual income tax); avoidances of double taxation (unilateral relief, double taxation agreements), net worth tax, sales tax, customs duties, excise duties, estate duties, gift duties; and tax incentives.

It is hoped at such time as a reprint of the survey is required that, apart from updating the existing country surveys, expansion to other countries (viz. Burma, Mongolia, Korea (People's Democratic Republic), Vietnam, Laos, Kampuchea, Kiribati, Tuvalu, Vanuatu, Nauru, Tonga, Maldives, Niue and perhaps Hawaii) will be feasible.

At present, the survey shows the author's wide use of documents from many countries and territories. It should find its place in all tax libraries of any significance, as it gives a quick informative survey. It is available to all members of the Asian-Pacific Tax and Investment Research Centre in Singapore, free of charge.

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Die Beratung, Verabschiedung und Auslegung von Gesetzen: Die Praxis in Grossbritannien (Dieser Artikel basiert sich auf einem Vortrag, der anlässlich des gemeinsamen Seminars der britischen und US-amerikanischen IFA-Gruppen im Oktober 1983 gehalten wurde) 531

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Consultation, Enactment and Interpretation of Legislation: The United Kingdom Approach

By Peter G. Whiteman, Q.C.

This paper was read at the Joint Seminar of the United Kingdom and United States Branches of the *International Fiscal Association,* held on 6 and 7 October 1983 in London. More papers presented at this conference will be published in forthcoming issues of the *Bulletin for International Fiscal Documentation.*

GENERAL PRINCIPLES OF CONSTRUCTION

Whilst the normal rules of statutory interpretation apply to taxing statutes, the Income and Corporation Tax Acts provide some special problems of their own. This is hardly surprising in view of the large and often uncoordinated body of law (with wording originating in some cases from as far back as 1803), the high rates of modern taxation and the complexities of modern economic and social arrangements which could hardly have been foreseen by legislators and draftsmen of an earlier period.

The statutory provisions can be divided into two main types; first, there are the original basic provisions, many of them enacted in the last century, which laid down in comparatively short and general terms the structure of income tax, the six Schedules, and the general system of deduction at source; superimposed on them is much more modern legislation which is more elaborate and contains many definitions and "deeming" provisions of considerable complexity. The general principles can be stated shortly. The onus is on the Crown to show that a taxing statute clearly imposes a charge on the person sought to be taxed. As Lord Normand concluded:

I seem in the end to be driven to that last refuge of judicial hesitation when confronted with a difficulty of interpretation, the doctrine that no tax can be imposed on the subject without words in an Act of Parliament clearly showing an intention to lay a burden on him.

But once this onus has been discharged a taxing statute must be construed strictly by reference to its actual words without regard to what might be expected to be found in it.

However, the principle that a person is not to be held to be chargeable unless there are plain words in the statute has been diminished in recent years to a certain extent. It is clear that recently the judiciary has often been looking at the "substance" of a transaction, so that if the taxpayer is within the spirit of the charge to tax, he may be held liable. As Lord Reid stated in 1971:

We seem to have travelled a long way from the general and salutary rule that the subject is not to be taxed except by plain words. But I must recognise that plain words are seldom adequate to anticipate and forestall the multiplicity of ingenious schemes which are constantly being devised to evade taxation. Parliament is very properly determined to prevent this kind of tax evasion, and if the courts find it impossible to give very wide meanings to general phrases the only alternative may be for Parliament to do as some other countries have done and introduce legislation of a more sweeping character, which will put the ordinary well-intentioned person at much greater risk than is created by a wide interpretation of such provisions as those which we are now considering.

In contrast, in 1974, in *Ransom v. Higgs* the House of Lords reiterated the principle that taxing statutes must be construed strictly. In general terms, a Court is not able to refer to parliamentary debates or consult the record thereof contained in Hansard. This matter was considered in detail in *Davis v. Johnson* ([1979] A.C. 264 at p. 337) where Viscount Dilhorne stated:

There is one other matter to which I must refer. It is a well and long established rule that counsel cannot refer to Hansard as an aid to the construction of statute. What is said by a Minister or by a member sponsoring a Bill is not a legitimate aid to the interpretation of an Act: see Craies on Statute Law, 7th ed. (1971), pp. 128-129. As Lord Reid said in Beswick v. Beswick *[1968] A.C. 58, 73-74:*

> *"In construing any Act of Parliament we are seeking the intention of Parliament and it is quite true that we must deduce that intention from the words of the Act. . . . For purely practical reasons we do not permit debates in either House to be cited: it would add greatly to the time and expense involved in preparing cases involving the construction of a statute if counsel were expected to read all the debates in Hansard, and it would often be impracticable for counsel to get access to at least the older reports of debates in Select Committees of the House of Commons; moreover, in a very large proportion of cases such a search, even if practicable, would throw no light on the question before the court".*

If it were permissible to refer to Hansard, in every case concerning the construction of a statute counsel might regard it as necessary to search through the Hansards of all the proceedings in each House to see if in the course of them anything relevant to the construction had been said. If it was thought that a particular Hansard had anything relevant in it and the attention of the court was drawn to it, the court might also think it desirable to look at the other Hansards. The result might be that attention was devoted *to the interpretation of ministerial and other statements in Parliament at the expense of consideration of the language in which Parliament had thought to express its intention.*

While, of course, anyone can look at Hansard, I venture to think that it would be improper for a judge to do so before arriving at his decision and before this case I have never known that done. It cannot be right that a judicial decision should be affected by matter which a judge has seen but to which counsel could not refer and on which counsel had no opportunity to comment.

In the same case, Lord Diplock considered the extent to which travaux preparatoires could be used. At page 329 the learned judge stated:

I have had the advantage of reading what my noble and learned friends Viscount Dilhorne and Lord Scarman have to say about the use of Hansard as an aid to the construction of a statute. I agree with them entirely and would add a word of warning against drawing too facile an analogy between proceedings in the Parliament of the United Kingdom and those travaux preparatoires which may be looked at by the courts of some of our fellow member states of the European Economic Community to resolve doubts as to the interpretation of national legislation or by the European Court of Justice, and consequently by English courts themselves, to resolve doubts as to the interpretation of Community legislation. Community legislation, viz. Regulations and Directives, are required by the Treaty of Rome to state reasons on which they are based, and when submitted to the Council in the form of a proposal by the Commission the practice is for them to be accompanied by an explanatory memorandum by the Commission expanding the reasons which appear in more summary form in the draft Regulation or Directive itself. The explanatory memoranda are published in the Official Journal together with the proposed Regulations or Directives to which they relate. These are true travaux preparatoires; they are of a very different character from what is said in the passion or lethargy of parliamentary debate; yet a survey of the judgments of the European Court of Justice will show how rarely that court refers even to these explanatory memoranda for the purpose of interpreting Community legislation.

A closer analogy with travaux preparatoires is to be found in reports of such bodies as the Law Commissions and committees or commissions appointed by government or by either House of Parliament to consider reforming particular branches of the law. Where legislation follows upon a published report of this kind the report may be used as an aid to identify the mischief which the legislation is intended to remedy; but not for the purpose of construing the enacting words in such a way as to conform with recommendations made in the report as to the form the remedy should take: Black-Clawson International Ltd. v. Papierwerke Waldhof-Aschaffenburg A.G. *[1975] A.C. 591. This does not mean, of course, that one must shut one's eyes to the recommendations, for a suggestion as to a remedy may throw light on what the mischief itself is thought to be but it does not follow that Parliament when it legislates to remedy the mischief has adopted in their entirety, or, indeed, at all, the remedies recommended in the report.*

The contrast with the way in which United States Courts will look to the Congressional record for assistance in construing legislation is striking.

For example, one may cite a by no means extreme illustration of that approach. In *Scottish American Investment Co. Ltd. v. Commissioner of Internal Revenue* (1949) 12 T.C. 49, Kern J. stated:

We turn now from a consideration of the factual background of the question before us to a consideration of its legislative background. The legislative history of the 1942 amendment, although not decisive, is illuminating. In the committee reports it was stated . . . . It is apparent that the Congressional intent was that foreign corporations which held stock of American companies and engaged in no other economic activities were not to be encompassed within Section 231(b), [since repealed: see now Code Sections 881 and 882], since they were not engaged in trade or business in the United States . . . . Our conclusion, buttressed as it is by the specific provisions of Section 211(b) and the legislative history of Section 231(b), is consistent with the cases and other authorities construing the phrases "doing business" or "engaged in business" in the field of corporation law.

A convenient summary of the foregoing principles in England, provided by Lord Donovan in 1971, is as follows:

It may be useful to recall at the outset some of the rules of interpretation which fall to be applied. First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices. . . . Secondly, ". . . one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used". (Per Rowlatt J. in Cape Brandy Syndicate v. I.R.C. *[1921] 1 K.B. 64, 71 . . .). Thirdly, the object of the construction of a statute being to ascertain the will of the legislature, it may be presumed that neither injustice nor absurdity was intended. If, therefore, a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted. Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid to its construction.*

This is in my opinion an admirable and concise statement of the law to be derived from the decided cases.

The peculiarities of the case stated procedure for tax appeals must also be borne in mind.

FORM AND SUBSTANCE

With these general considerations in mind, we now come to what is often the vital problem; how far may a court stretch the wording of a statute to cover a particular set of facts, where those facts have clearly been created by a taxpayer in order to avoid or minimise his tax and the literal interpretation of the statute is not, at first sight, apt to cover them? Two types of approach are possible: first, the courts may give a wide construction to the statutory words so as to bring the facts clearly within their ambit; as has been shown above, this approach can only be adopted in cases where the words used are imprecise and can fairly be interpreted to have a wide meaning. General words, such as "adventure in the nature of trade" and "profits of trade" have been so interpreted so as to cover a wide variety of transactions. The other possible approach is to take a broad view of the facts and to say that they represent a state of affairs which is substantially within the terms of the statutory provision. In a number of earlier cases this type of approach was used, but in *I.R.C. v. Westminster* this approach was held to be limited to ascertaining "the substance" from the legal rights and obligations of the parties determined upon ordinary legal principles. When construing documents the surrounding circumstances must be looked at and the name given by the parties to a transaction does not necessarily decide its nature, but documents, such as deeds of covenant, can only be disregarded for tax purposes when they are not bona fide, nor intended to be acted upon, and are only used as a cloak to conceal a different transaction. A transaction will not readily be regarded in this latter sence. In *I.R.C. v. Westminster,* Lord Tomlin said, in a passage which has often since been quoted:

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 follow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.

So matters rested for many years until the landmark case of *W.T. Ramsay Ltd. v. I.R.C.* [1981] S.T.C. 174. However, some two years after the House of Lords handed down judgment the question remains what did *Ramsay (together with I.R.C. v. Burmah Oil & Co. Ltd.* [1982] S.T.C. 30) decide. Are the English courts going to approach form versus substance matters like the United States Courts, as typified by *Knetsch v. United States* (1960) 364 US 361 and *Gilbert v. Commissioner of Internal Revenue* (1957) 248 F. 2d. 399 (*per* Learned Hand J.). A somewhat more recent example in the United States, and a case which the author particularly enjoys, is *Goldstein v. Commissioner 364 F. 2d. 734.*

Waterman Circuit Judge:

We hold, for reasons set forth hereinafter, that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.

Returning to *Ramsay,* how far did the House of Lords take us down a path that the American Courts have been treading for years. Looking at the speeches in the House, it would seem a long way: however, judges at first instance, and now the Court of Appeal, seem to be setting limits to the *Ramsay* decision which are now obvious on its face. The clearest judicial explanation of what *Ramsay* decided (limiting it as indicated above) is set out in the judgment of Oliver L.J. in *Furniss v. Dawson* [1983] S.T.C. 549 at p. 562:

I turn back, therefore to a consideration of the two passages from the speeches of Lord Wilberforce and Lord Fraser on which counsel for the Crown particularly relies, but with the caveat that both of them must be considered in the context of the decision in which they occurred. I ask, therefore, initially what was it in fact that Ramsay *decided? As I see it, it decided three things. First, it established that there is nothing in the* Westminster *principle which compels a consideration of individual transactions separately from a preconceived chain or series of transactions of which they form merely a part. Secondly, it established that where one finds a series of preconceived transactions which are entered on solely for fiscal purposes and are clearly interconnected and mutually dependent on one another one should look at the overall transaction to ascertain what has been and what was intended to be achieved. Thirdly, it established that if what you find on such a consideration is that nothing whatever has been achieved because the individual steps taken cancel one another out, you are entitled then to ignore the fiscal consequences which might otherwise have resulted from each of those individual steps considered in isolation. That as I see it represents the substance of the general principle deductible from the decision, although I would not wish what I have said to be treated as an exhaustive analysis.*

In the light of *Ramsay* it is interesting to speculate how far United States authorites will be cited in English Courts. Is it now possible to have a Reverse *Ramsay*; see *Pattison v. Marine Midland Ltd.* [1983] S.T.C. 269?

EXTRA-STATUTORY CONCESSIONS AND STATEMENTS OF PRACTICE

As the Revenue are usually parties to tax cases the practice of the Revenue is of considerable importance. In certain situations where the law is clear, but is either considered to be unfair to taxpayers, or its application involves serious administrative difficulties, the Revenue do not enforce the strict letter of the law; some of the situations are published by them as "Extra-Statutory Concessions" or Statements of Practice; others are published as answers to Parliamentary Questions by the Chancellor of the Exchequer or his deputies; others are not published at all but are known to practitioners, whose clients benefit from them. These concessions have practical, but no legal, effect; if a person considers that he comes within one, but the Revenue disagree, there is no way of litigating the extent of the concession; the courts have to apply the strict law.

The legal basis, if any, of Extra-Statutory Concessions was considered by Lord Edmund-Davies in *Vestey v. I.R.C.* [1980] S.T.C. 1 at page 35:

My Lords, it is surely high time to consider the basis of this claim by the executive to make such extra-statutory concessions. It is, of course, well known that published lists of concessions have existed for many years. The first was in 1944, though in practice they have existed in one form or another for a much longer period. But, beneficent and relatively harmless though such concessions may have been in most cases, it is difficult to reconcile them with the view expressed by Lord Loreburn L.C. in Drummond v. Collins that:

> *"Lord Cairns long ago said that if the person sought to be taxed comes within the letter of the law, he must be taxed. And though there have been cases in which the letter of the law has been disregarded in view of other statutory language, I think it can be only in case of necessity. It must be a necessary interpretation."*

It has recently been pointed out in an article to which I am considerably indebted that Sir Stafford Cripps said in 1947 that they had come into existence "without any particular legal authority under any Act of Parliament, but by the Inland Revenue under my authority". And, despite the reliance sometimes placed on the Income and Corporation Taxes Act 1970, S.115(2), the Taxes Management Act 1970 S.1, and the Inland Revenue Regulation Act 1890, S.1, the fact is that there exists no statutory support for the assessment procedure adopted in the present case.

Wholly in line with such authoritative declarations was the observation of Scott L.J. in Absalom v. Talbot *that:*

> *"No judicial countenance can or ought to be given in matters of taxation to any system of extra-legal concessions. Amongst other reasons, it exposes revenue officials to temptation, which is wrong, even in the case of a service like the Inland Revenue, characterised by a wonderfully high sense of honour. The fact that such extra-legal concessions have to be made to avoid unjust hardships is conclusive that there is something wrong with the legislation."*

The rejection of Extra-Statutory Concessions as having any role to play in the judicial interpretation of statutes must be contrasted again with the approach of the United States Courts in appropriate cases. There a body of law and interpretation contained in the Regulations can play a vital role in appropriate circumstances. Even where the Regulations are interpretative only the vital role they can play in the judicial process is illustrated by, for example, *Commissioner of Internal Revenue v. Nubar* (1950) 185 F. 2d. 584 at page 587 (Parker Chief Judge):

It is well settled that a regulation [now 1-81-2(b), definition of residence] of long standing, such as this, promulgated by the department charged with the enforcement of the statute is entitled to great weight in its interpretation and will be enforced unless unreasonable or inconsistent with the statute: and this regulation has been recognised as valid and has been enforced by the Courts in determining what constitutes non-residence. We think it effectively disposes of taxpayer's contention *that he was a non-resident alien.*

THE RELATIONSHIP OF TREATIES TO THE DOMESTIC CODE

In the United States treaties are of fundamental importance. Article VI, paragraph 2 of the U.S. Constitution declares that all treaties together with the Constitution itself and all laws in pursuance thereof "shall be the supreme law of the land". Code Sections 7852 (d) and 894(a) show the supreme nature of treaty provisions. The United States Courts regard treaty and code law as co-equal, so that if there is a conflict the latter in time will prevail: see Section 31 of the Revenue Act of 1962 and Section 110 of the Foreign Investors Tax Act 1966. Of course, of far greater importance was the Foreign Investment in Real Property Tax Act 1980, which established that the Act could override all conflicting provisions of treaties after 31 December 1984. See Section 1125(c) of the Code which provides:

(c) SPECIAL RULE FOR TREATIES –

(1) IN GENERAL – Except as provided in paragraph (2), after 31 December 1984, nothing in section 894(a) or 7852(b) of the Internal Revenue Code of 1954 or in any other provision of law shall be treated as requiring, by reason of any treaty obligation of the United States, an exemption from (or reduction of) any tax imposed by section 871 or 882 of such Code on a gain described in Section 897 of such Code.

(2) SPECIAL RULE FOR TREATIES RENEGOTIATED BEFORE 1985 – . . . .

In the United Kingdom, the rule is similar and in particular a piece of domestic legislation may override a treaty commitment. Thus, for example, this year a clause was tabled to the Finance Bill in relation to the Unitary Tax System adopted by certain states of the United States, which would have the effect of overriding the United Kingdom–United States Double Taxation Agreement. That clause read as follows:

To move the following Clause:

(1) Section 497 of the Taxes Act (relief by agreement with other countries) shall be amended as follows.

(2) In subsection (1)(d) of that Section before the words "for conferring on persons not resident in the United Kingdom" there shall be inserted the words "subject to the provisions of subsections (1A) and (1B) below".

(3) After subsection (1) there shall be inserted –

(1A) Notwithstanding the terms of any arrangements a company not resident in the United Kingdom shall not be entitled to credit under Section 86 of the Finance Act 1972 in respect of qualifying distributions made to it on or after 1st January 1984 if that company or any associated company of that company:

(a) is resident or carrying on a trade in the territory with the government of which the arrangements are made; and

(b) is incorporated or has its principal place of business in a political sub-division of that territory and that sub-division in determining the tax liability of a company carrying on a trade or business in that sub-division takes into account the assets, income, deductions, receipts or outgoings of that company, or of any associated company of that company in any third territory; and

(c) carries on a trade in the United Kingdom or has one or more associated companies which carry on a trade in the United Kingdom.

(1B) For the purposes of subsection (1A) –

(a) a company which is resident outside the United Kingdom, shall be regarded as resident in a territory in which it is liable to tax by reason of incorporation, domicile, residence or place of management;

(b) Section 302 of the Taxes Act (meaning of "associated company" and "control") applies. . . .

MALAYSIA: FOREIGN CONTRACTORS

Section 107A of the Income Tax Act 1967

By Leong Khai Wah

INTRODUCTION

The Hon. Minister of Finance in his 1983 Budget proposals introduced a new Section 107A to the Income Tax Act, 1967 (ITA). The Finance (No. 2) Bill 1982 incorporating the 1983 budget proposals, which subsequently was passed by Parliament, received Royal Assent on 30 December 1982. The Bill was gazetted on 31 December 1982 and the proposed Section 107A thus came into force on 1 January 1983 for Malaysia (including Sabah and Sarawak).

The Government of Malaysia has through the Department of Inland Revenue expressed the necessity to tighten tax compliance procedures for non-resident employees and contractors. Problems created by certain foreign contractors by their indifference to local tax obligations could have exceeded allowable proportions to prompt the Government to introduce withholding tax requirements on contract payments.

The authorities foresee compliance problems becoming more serious with the greater influx of foreign contractors, as a result of their more advanced technology, getting a bigger share of the public and private development projects envisaged in the Fourth Malaysian Plan. The problems are compounded by non-resident contractors who perform their services from offshore bases and the geographical constraints imposed on the Revenue's mobility in the collection of taxes due. The Revenue is aware of the inevitable time lag between the time payments are made to non-resident contractors and the time information is received by them. This is a disadvantage since by the time the Revenue gets to the contractor he could have completed the contract and pulled out of Malaysia leaving the Revenue with no means for recovery of any taxes due.

It may be deduced from the specific wording of Section 107A that the Revenue has also found it difficult to enforce satisfactory and timely tax compliance by non-resident employees of foreign contractors. There are, however, published data or official statements on the seriousness of non-compliance with their tax obligations by non-resident contractors and their employees in dollar terms, but the reasons given by the Revenue easily explain the need for the new section.

OBJECTIVE OF SECTION 107A

There is no change in the charge to tax on profit made by non-resident contractors, whose chargeability continues to be determined by the existing provisions of the ITA, 1967. Section 107A only authorizes the withholding of monies by the payer (contract owner) on account of tax which is or may be payable by a non-resident contractor or his employees. The excess, if any, arriving from the actual liability compared to monies withheld will be refunded to the non-resident contractor.

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The proposal of the Hon. Minister of Finance in his 1983 budget speech is reproduced below. The objectives of the Government are quite clear:

> Withholding Tax on Non-Resident Contractors and Professionals
>
> In order to resolve problems of taxing non-residents and at the same time to protect government's revenue, it is proposed that
>
> (i) All persons making payments to a non-resident person who is a contractor, consultant or professional shall upon paying or crediting such payments, deduct therefrom tax at the rate of 15% of the contract payment pertaining to the service portion of the contract.
>
> (ii) All persons making payments to a non-resident person who is a contractor shall upon paying or crediting such payments, deduct therefrom a further 5% of the contract payment pertaining to the service portion of the contract to cover the tax obligation of the employees.
>
> The taxes so deducted in (i) and (ii) above are to be accounted to the Revenue Department within 30 days of such payments. These deductions, however, are not a final tax. The final liability of tax will be computed when the taxpayer files his income tax returns.

The full text of Section 107A is published in the Appendix, at the end of this article.

Effective date: 1 January 1983

All contract payments made on or after 1 January 1983 in respect of services under a contract are subject to the provisions of Section 107A. Withholding tax will therefore apply even to payments made in 1983 for contract works performed or contracts signed prior to 1 January 1983 if such sums, although due as at 31 December 1982, were paid on or after 1 January 1983.

Guidelines to Art. 107A issued by the Government have been published in 1 *Asian-Pacific Tax and Investment Bulletin* 1-2 (1983) at 18 (Asian-Pacific Tax and Investment Research Centre, Singapore).

Rate of withholding tax

The rate is:

(i) 15% of the service portion of contract payments to a non-resident contractor, in respect of tax of the non-resident contractor himself, and

(ii) 5% of the service portion of contract payments in respect of tax of employees of the non-resident contractor.

The total rate of withholding tax is therefore 20% of the *service portion* of contract payments made to a non-resident contractor. However, the rate of withholding tax can be varied by the Director General of Inland Revenue (DGIR) under Section 107A(1)(i) proviso. Other than in the case of small profits, which may not be easily estimated with a reasonable degree of accuracy to be convincing, it is difficult to see the DGIR exercising the proviso to reduce the rate.

Tax residence – corporations

The 20% withholding tax enacted under Section 107A affects non-resident contractors. In this connection, it is important to consider the concept of company residence under the Malaysian Income Tax Act. Although most Malaysian incorporated companies are resident here, a company may be incorporated in Malaysia, yet not be resident in Malaysia. Conversely, a foreign incorporated company may be resident in Malaysia. The tests for residence are provided in Section 8 of the Income Tax Act, 1967 as amplified by case law.

Companies

Section 8 of the Income Tax Act provides as follows:

> Section 8(1)(b):
> a company or a body of persons (not being a Hindu joint family) carrying on a business or businesses is resident in Malaysia for the basis year for a year of assessment if *at any time* during that basis year the management and control of its business or of any one of its businesses, as the case may be, are exercised in Malaysia; and
>
> Section 8(1)(c):
> any other company or body of persons (not being a Hindu joint family) is resident in Malaysia for the basis year for a year of assessment if at any time during that basis year the management and control of its affairs are exercised in Malaysia by its directors or other controlling authority.
>
> Section 8(2):
> If it is shown that it has been established as between the Director General and a company or body of persons for any tax purpose that the company or body was resident in Malaysia for the basis year for any year of assessment, it shall be presumed until the contrary is proved that the company or body was resident in Malaysia for the purposes of this Act for the basis year for every subsequent year of assessment.

The term "body of persons" does not include a partnership.

The provisions of Section 8(1)(b) and (c) reflect the decisions of the leading cases on residence – *Calcutta Jute Mills Co. Ltd. v. Nicholson* ITC 83 (1876), *Cesena Sulphur Co. Ltd. v. Nicholson* ITC 138 (1876), *De Beers Consolidated Mines Co. Ltd. v. Stephens* 5 TC 553. Those cases showed that a company is resident where the central management and control of the company is exercised and not where it is incorporated. In most cases, a reference to management and control is a reference to control by the directors of the company. Therefore, the country in which directors' meetings are held is of great importance when determining the residence of a company.

Where at any time in a calendar year a meeting of directors is held in Malaysia and management issues are considered, the company concerned would be resident in Malaysia for that year.

However, where management and control do not in point of fact lie with the directors but with another person, e.g. the parent company, a company may be held to be resident in the country where decisions by the parent company are made (*Bullock v. The Unit Construction Co. Ltd.* 38 TC 712 (1959)).

Who must withhold the tax

The responsibility of withholding lies with the person who is liable to make contract payments to a non-resident contractor. Government agencies and statutory bodies are not exempted. Payments to non-resident contractors made outside Malaysia for services provided under a contract in Malaysia do not escape withholding. Therefore, it is futile to make arrangements with financial institutions abroad to pay or credit non-resident contractors as the responsibility still lies with the contract owner or main contractor as the case may be.

A payer must, upon paying or crediting such contract payments, deduct tax at 20%, and whether or not the tax is so deducted pay the DGIR within one month of the date of payment or crediting. Withholding tax is, therefore, deductible at the point of payment or credit, whichever is earlier. Whilst the point of payment may be easily understood, the concept of the point of credit may be less clear. To follow general principles, a credit would arise when a debt which is due and payable is credited in the books of the person liable for the debt. Creation of provisions or accruals would not result in credits unless the liabilities are payable on demand.

Failure to deduct tax will result in a debt due to the Government. The DGIR will sue the defaulting payer for recovery of this debt. In addition, a new paragraph has been introduced to Section 39 of the Income Tax Act to disallow a claim for deduction of the contract payments in the accounts of the payer if no withholding was made or if withholding was made and paid to the DGIR late. From the above, it can be seen that the penalties for default in complying with the withholding provisions are sufficiently deterrent.

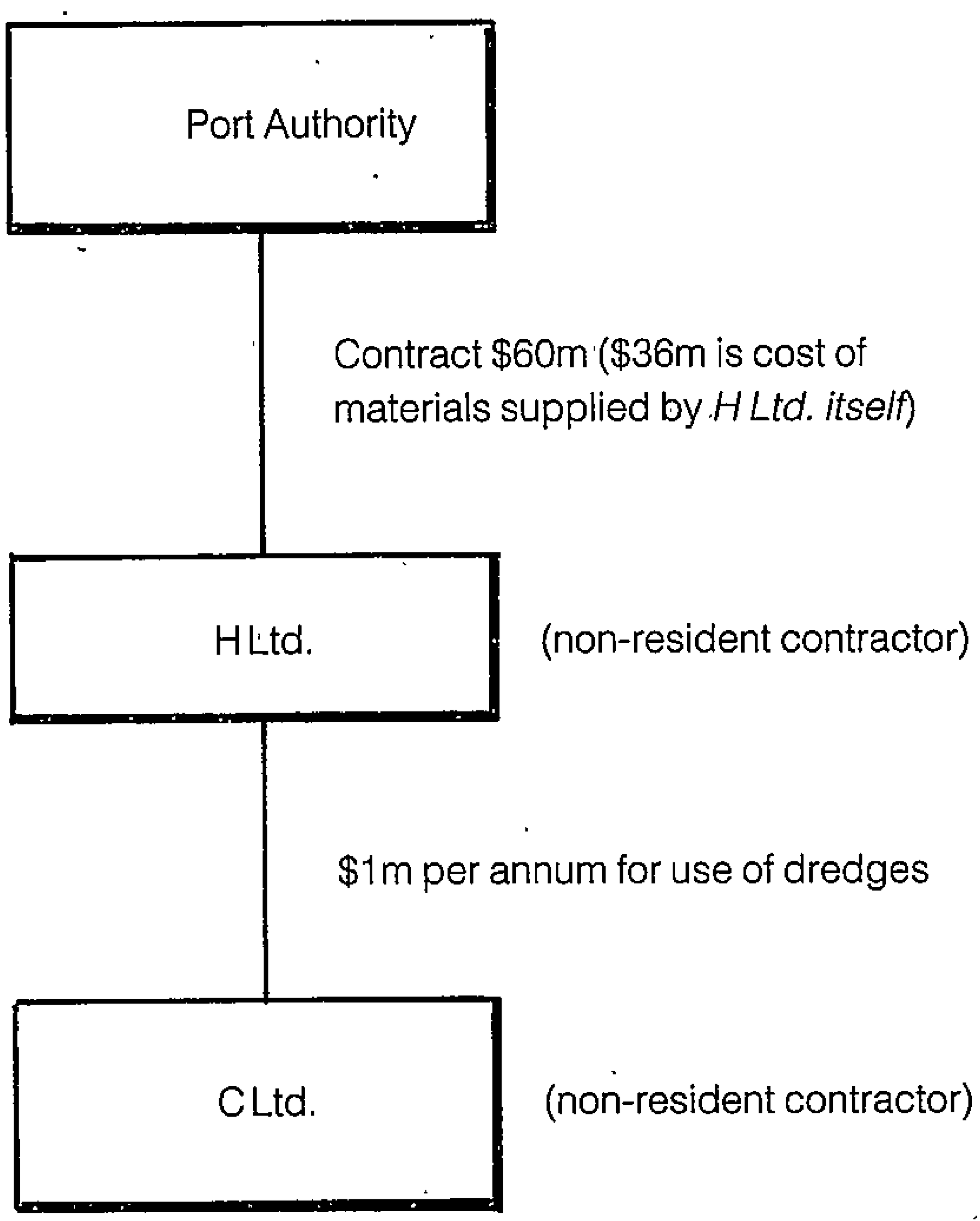
Scope of services under a contract

As mentioned earlier, the 20% withholding tax is applicable to the *service* portion of a contract only. What constitutes services under a contract is defined in Section 107A(5). The cost of plant and machinery and materials is excluded if supplied by the non-resident contractor *himself*. However, in certain situations, the cost of equipment is included in the service portion too. This is stipulated in Section 107A(5)(b). The following example may help to clarify.

Example

A Malaysian Port Authority enters into a contract with H Ltd. (a non-resident contractor) to repair and deepen docks and wharves. The total value of the contract is $60,000,000. The service portion is, say $24,000,000. H Ltd. in order to perform its contract has to lease dredges from C Ltd. (a non-resident contractor) for $1,000,000 per annum.

Diagramatically:



The above arrangement will result in the service portion of H Ltd.'s contract adjusted to $25,000,000, determined as follows:

Service portion of contract of H Ltd. with Port Authority	$24,000,000
Supply of dredges contracted with C Ltd.	$ 1,000,000
	$25,000,000
Withholding tax is $25,000,000 @ 20%	$ 5,000,000

The following may have to be highlighted:

(i) In relation to H Ltd., the supply of the dredges is by a person other than H Ltd. itself. The cost of leasing must therefore be added to the service portion of the contract.

(ii) In relation to C Ltd., the supply of the dredges is by itself and not a person other than itself. Consequently when H Ltd. pays C Ltd. $1,000,000 there is no requirement on H Ltd. to deduct tax. Refer Section 107A(5)(b).

Non-resident employees

The tax rate as indicated earlier is 5% of the service portion of the contract payment. The 5% deduction applies to all employees including those under the Income Tax (Deduction from Emoluments: East Malaysia) Rules, 1967, in Sabah and Sarawak. In practice, however, the 5% may be dispended with if the Inland Revenue Department in East Malaysia is satisfied that the employees of a non-resident contractor are in fact complying with the Rules.

An exemption or refund may also be applied for in West Malaysia by providing certain tax particulars of non-resident employees evidencing that satisfactory arrangements for the payments or recovery of employees' tax are in force.

Partnerships

A person for the purposes of Section 107A includes a partnership. Where a partnership is the payer it must deduct tax at 20%. Where a partnership is the recipient, deduction of 20% would apply to the percentage of the contract payment relating to the non-resident partner's profit-sharing rates. In this case the resident status of the partners has to be ascertained under existing residence provisions of the ITA. Under the Malaysian system, a partnership is not a tax entity for income tax purposes. The partners are, and tax is charged on them individually on their share of adjusted income from the partnership.

Joint ventures

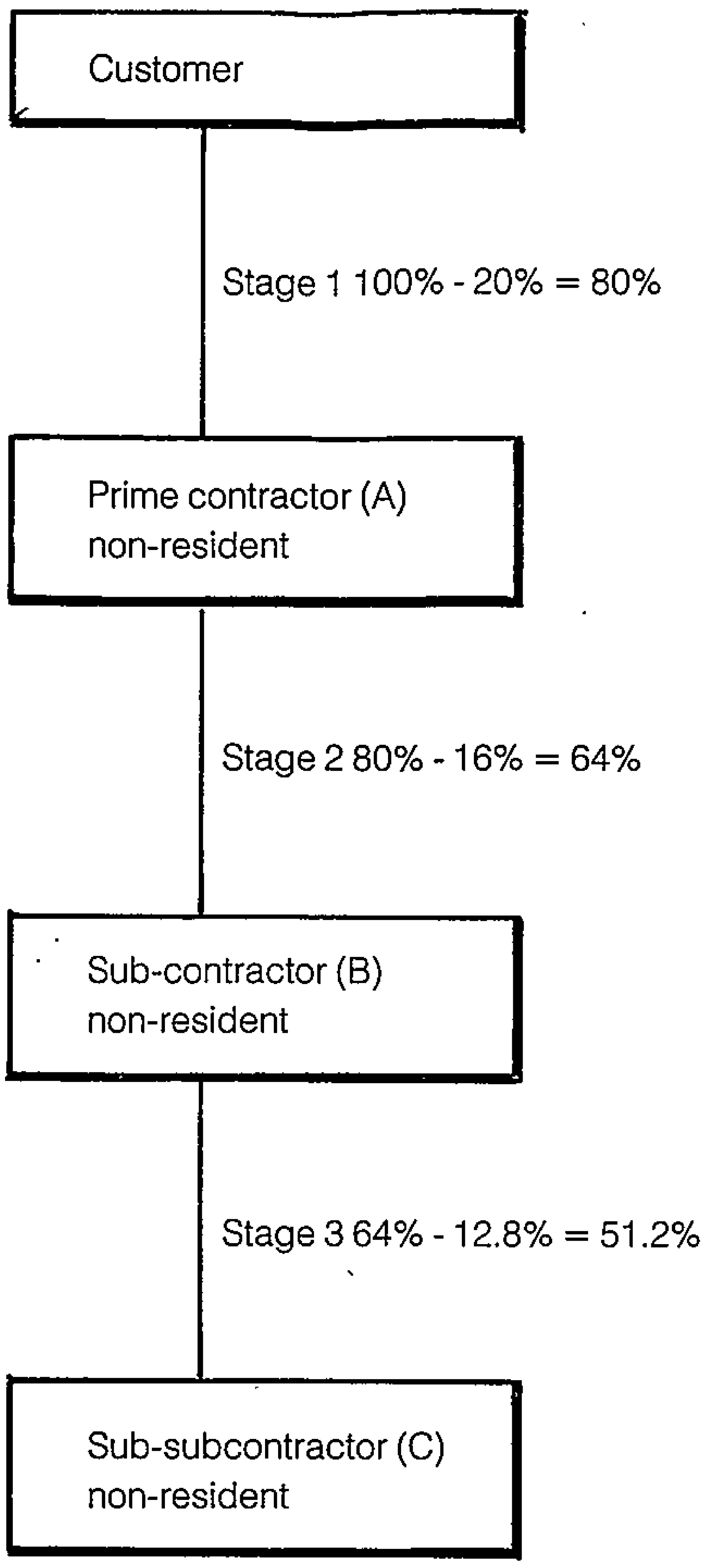
If a joint venture is a company incorporated under the Malaysian Companies Act, residence status is determined by the test of management and control. The joint venture partner's residence status will have no bearing on the residence status of the company.

Where a joint venture conducts its business under a partnership contract, what has been said for partnership above would apply. It is therefore essential for the payer who makes contract payments to a partnership or joint venture to find out the residence status of the parties and the ratio of profit and fee shares.

Multi-stage contract structure

The deduction under the provisions of Section 107A may result in a multi-stage situation. The Revenue is quite prepared to look into cases of multi-stage withholding for exemption or reduction of the rate if it is evident that deduction at a certain stage becomes excessive compared to the reducing margin.

Diagramatically:



Stages 1, 2 and 3 are subject to withholding tax on services under the contract. Application for avoidance of multi-stage deduction is expected to originate from (B) and (C). It is recognized that multi-stage deduction if applied down the line may give rise to onerous and unfair situations and create serious cash flow problems to the parties involved.

Determination of the service portion of a contract

The payers and the non-resident contractor are the competent persons to determine on the basis of contract documents the service portion of a contract. The Malaysian tax authorities may seek clarifications on the taxable base if necessary.

Generally the service portion may be identified on an overall contract basis or on an invoice-by-invoice basis. Whatever basis is adopted, consistency in use is essential. The basis must be able to withstand scrutiny and be properly documented.

Briefly, the following payments to non-residents are not caught by Section 107A:

(i) Payment of lease rentals to non-resident lessors for equipment used in Malaysia. However, the leasing or supply of equipment in circumstances akin to the Example given earlier will fall within the deduction provisions of Section 107A.

(ii) Payments to non-resident shippers for transportation of goods into Malaysia.

(iii) Payments for bare boat charter. However, payments for time charter in connection with a contract project in Malaysia are liable to withholding tax.

(iv) Payments not constituting a royalty by a person for services in relation to the purchase of equipment from a non-resident, not in connection with a contract project. Such payments may be for the evaluation and testing of equipment before being used in the manufacturing activity of a person. However, services of a technical nature such as in connection with the installation or operation of the equipment may constitute a "royalty" for withholding tax under Section 109 of the ITA.

(v) Contract payments in respect of services made to a non-resident bank. Where a bank is the payer, whether it is a resident or not, deductions must be made.

DISTINCTION BETWEEN SECTION 107A AND SECTION 109 WITHHOLDING TAX

The word "withholding" is not found in Section 107A. The word is used here and elsewhere in connection with Section 107A, in its ordinary sense. The deduction of tax is not to be equated with a tax levied on the basis of a known liability, but is a payment in advance of tax later to be determined. This is not to be confused with the withholding of tax under Section 109 on interest and royalty paid or credited to a non-resident. The tax to be deducted from interest and royalty is at the rate applicable to a non-resident, i.e. 15% of gross. Unless the non-resident has other sources of taxable income in the tax year, the 15% tax deducted will be the final tax as interest and royalty is taxed at gross.

CONCLUSION

It seems to be an emerging trend in most Asian countries to exploit the advantages available through a system of advance tax withholding. Malaysia in this respect has just begun to avail itself of the advantages. The Indonesian authorities now seek to impose a withholding tax on most payments to non-residents (other than for goods supplied) which are allowable deductions against assessable income. In the Philippines, payments to service contractors engaged in petroleum exploration are already subject to a 15% tax deduction. In the Republic of Korea, payments to non-residents are subject to withholding tax at rates ranging from 2% to 25% depending on the nature of income or services. Some withholding systems are more sophisticated or cover a wider spectrum of income than others.

It is not the intention of this article to pass judgment on the rationale behind Section 107A or to make a comparison with similar provisions in other countries. To draw a similarity may be impossible as each country has its own reasons and objectives. In the final analysis the common objective undeniably is the protection of revenue. For Malaysia, this is a new tax law and many multifarious problems are expected to rear their heads for solutions.

The writer hopes to have attempted successfully in highlighting important aspects of Section 107A and areas of its application.

APPENDIX

SECTION 107A

(1) Where any person (in this section referred to as "the payer") is liable to make contract payment to a non-resident contractor in respect of services under a contract, he shall upon paying or crediting such contract payment deduct therefrom tax at the rate of –

(a) fifteen per cent of the contract payment on account of tax which is or may be payable by that non-resident contractor for any year of assessment; and

(b) five per cent of the contract payment on account of tax which is or may be payable by employees of that non-resident contractor for any year of assessment;

and (whether or not that tax is so deducted) shall within one month after paying or crediting such contract payment render an account and pay the amount of that tax to the Director General;

Provided that the Director General may –

(i) give notice in writing to the payer requiring him to deduct and pay tax at some other rates or to pay or credit the contract payment without deduction of tax; or

(ii) under special circumstances, allow extension of time for tax deducted to be paid over.

(2) Where the payer fails to pay any amount due from him under subsection (1), the amount which he fails to pay shall be a debt due from him to the Government and shall be payable forthwith to the Director General.

(3) Where in pursuance of this section any amount is paid to the Director General by the payer or recovered by the Director General from the payer –

(a) the Director General shall apply the amount paid or recovered under subsection (1)(a) towards payment of the tax payable for any year of assessment by the non-resident contractor to whom the payer was liable to pay the contract payment to which that amount relates;

(b) the Director General shall refund the amount paid or recovered under subsection (1)(b) to the non-resident contractor to whom the payer was liable to pay the contract payment to which that amount relates as and when the Director General deems appropriate; and

(c) if the payer has not deducted any amount in paying the contract payment with respect to which the amount relates, he may recover the amount from the non-resident contractor as a debt due to the payer.

(4) In relation to any case, nothing in subsection (1)(b) shall prevent the deduction of any tax (not being tax deducted in accordance with this subsection) in accordance with Section 107.

(5) In this section –

"contract payment" means any payment, not being a payment that is royalty within the meaning of section 2(1) made for services under a contract to the non-resident contractor or his agent or any other person acting on his behalf;

"contract project", in relation to any non-resident contractor, includes any undertaking, project or scheme, being an undertaking, project or scheme carried on, carried out or performed in Malaysia;

"non-resident contractor" means any person who is not resident in Malaysia within the meaning of sections 7 or 8 and who, under a contract or a subsidiary contract (not being a contract of service or apprenticeship) or an agreement or arrangement undertakes (otherwise than as an employee) any services under a contract;

"person" includes a partnership;

"professional service", in relation to any non-resident contractor, includes any advisory, consultancy, technical, industrial, commercial or scientific service;

"services under a contract" in relation to any non-resident contractor, means –

(a) the performing or rendering of any work or professional service in Malaysia, being work or professional service in connection with, or in relation to, any contract project; or

(b) the granting, providing or supplying of the use, or the right to use, in Malaysia (whether or not in connection with or in relation to any contract project), any personal property or any services of any person being a person other than the non-resident contractor.

India: Revenue Performance of Agricultural Taxes during the Plan Periods

By Varkey K. Titus

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Other publications on Indian agricultural taxes by Dr. Titus are:
"The political economy underlying Indian agricultural taxation", *Western Tax Review*, Spring 1982 at 53-71; and
Agricultural taxation in a developing economy: a case study of India (Bombay: Asia Publishing House, 1983).

The 1972 reorganization of the Planning Commission to formulate policies for a new agricultural development strategy marked a noticeable shift in India's developmental orientation. The growth-oriented agricultural policies of the past decades, aided by subsidized inputs, price supports for agricultural products, and investments directly aimed at benefiting the agricultural sector, have resulted in moderate increases in productivity and income in this sector.[1] Because of the highly unequal distribution of agricultural land and other assets, the major beneficiaries of these policies were a minority of rich farmers. Since the early 1970s, Indian governments have emphasized the importance of increasing agricultural production, along with better employment opportunities and a higher standard of living for the rural poor. The success of these equity-oriented rural development strategies depends on the nation's ability to mobilize and allocate resources for these programs. Since agriculture is the largest economic sector in India, generating nearly 50% of the net domestic product, it is important to examine the revenue performance of this sector. If the existing fiscal instruments are unable to achieve the goals and objectives sought, they need to be restructured to meet the new challenges.

AGRICULTURAL TAXATION FOR DEVELOPMENT

The prevailing interest in agricultural and rural development has renewed the importance of examining agricultural taxation as a development policy instrument. Bird points out, "Agricultural taxation is an important instrument of development policy, simply because agriculture is important" (1974: ix).

In the past, developmental economists have pointed to the need for an "extraction" of the agricultural sector, so that resources for the development of non-agricultural sectors could be provided (Mathew 1968; Lewis 1967; Gandhi 1966; Owen 1966; Wald 1965). This line of argument was based on the historical experience of Japan and the U.S.S.R. These countries were successful in mobilizing the agricultural surplus and in utilizing it for their industrial development. The following statement summarizes the conventional arguments for agricultural taxation:

> Imposing heavier taxation on the agricultural population would force the farmers to bring forth increased market supplies. Many side effects would occur. Monetization of the agricultural economy would improve economic attitudes and enlarge the tax base for indirect taxation; commercialization of agriculture would impart to the agricultural sector a sensitivity to prices and other market stimula....Increased agricultural taxation would conserve foreign exchange needed to import machinery and capital equipment for new industries; it would control inflationary pressures....Agricultural taxation would increase the labor force available for non-farm jobs by making it economically difficult for unemployed and unproductive labor to stay on the farm....This mobility, in turn, would have significant implications, affecting the attitudes of the people towards work and leisure, income and expenditure, and towards family planning, with its important consequences in terms of population growth (Gandhi 1966: 2).

It is also theorized that by levying heavy land taxes, rich land holders will be forced to sell off part of their land. By

1. The appendix shows the public sector outlay for agriculture and the various sectors during the plan periods.

providing adequate means and incentives, the government can aid the poor peasants to acquire these lands. Along with this kind of distribution of land, Gandhi also argues that heavier land tax is the only way to make rich farmers pay their "fair share" of taxes (1966: 18). In recent years, a reorientation of agricultural taxation has been emerging (Mellor 1976; Johnston and Kilby 1975; Bird 1974).

According to this new view, less emphasis is placed on the transfer of resources from agriculture to the non-agricultural sectors. Agricultural taxation is emphasized for the development of agriculture and the rural areas.

TYPES OF DIRECT AGRICULTURAL TAXES

The scope of this paper is limited to the examination of the revenue performance of the direct agricultural taxes from 1950-51 to 1979-80. However, it is reasonable to point out that independent India inherited an impoverished agrarian economy and the ruins of a long history of land taxes.[2] Apart from the two major changes of elimination of middlemen as the tax collectors and the constitutional provision of establishing agricultural taxation under the individual states' jurisdiction, no other major changes have been undertaken in India since independence.[3]

Table 1 provides a summary list of direct agricultural taxes levied in the states of the Indian Union. Major agricultural taxes are land revenue[4] and agricultural income tax. Additional taxes are levied by some states in the form of cesses on cash crops and as surcharges on land revenue. These cesses and special levies are not significant in their share of total agricultural taxes, and there are considerable difficulties in obtaining detailed data on these. The limitations of the available data on agricultural taxes are well expressed by the Government of India's Committee on Taxation of Agricultural Wealth and Income.[5]

In terms of revenue yield and the number of states levying it, land revenue is the most important form of agricultural taxation in India. Every state in the Union (except the newly reorganized states of Manipur and Nagaland) uses land revenue in one form or another. Even though, historically, land revenue was the single most important type of agricultural taxation, there were a few attempts in the British period to introduce some form of agricultural income taxation.[6] However, it was only in 1938, following the Government of India Act of 1935, that agricultural income tax was introduced in a number of states. This Act of 1935 empowered the provinces with the authority to tax agricultural income. The present Indian constitution also retains this power for the state governments. As a result of the states' authority to impose taxation on income from agriculture, this source of income is not subject to the income tax of the Central Government. According to Merillat, "states exercise this power only sparingly" (1970: 51). The Government of India's Committee on Taxation of Agricultural Wealth and Income (1972) reported that, in impact and yield, agricultural income taxation has made little headway anywhere except in the case of plantations (p. 120). As shown in Table 1, at present only 8 states levy agricultural income tax.

Table 1
Direct taxes on agriculture levied by the states

States	Type of direct taxes on agriculture
Andhra Pradesh	Land revenue; cesses based on land revenue and betterment levy
Assam	Land revenue; cesses based on land revenue (local rate); betterment cess and agricultural income tax
Bihar	Land revenue; cesses based on land revenue; betterment levy and agricultural income tax
Gujarat	Land revenue and cesses based on land revenue (local fund cess)
Haryana	Land revenue; surcharge on land revenue; special charge on land revenue; commercial crop cess and betterment levy
Himachal Pradesh	Land revenue and cesses based on land revenue (local rate)
Jammu and Kashmir	Land revenue; cesses based on land revenue and surcharge on land revenue
Kerala	Land tax; plantation tax; betterment levy and agricultural income tax
Madhya Pradesh	Land revenue; cesses based on land revenue; surcharge on land revenue and betterment levy.
Maharashtra	Land revenue; cesses on commercial crops; betterment levy and agricultural income tax
Manipur	No direct tax on agriculture
Meghalaya	Land revenue (only in select parts of the districts)
Mysore	Land revenue; cesses on land revenue (local cess; health cess and education cess); betterment cess and agriculture income tax)
Nagaland	No direct tax on agriculture
Orissa	Agricultural income tax and betterment levy; land revenue (abolished in 1967)
Punjab	Land revenue; surcharge; special charge; local rate and crop cess
Rajasthan	Land revenue; surcharge on land revenue and betterment levy
Tamil Nadu	Land revenue; surcharges and cesses; betterment levy and agricultural income tax
Uttar Pradesh	Land revenue and large holding tax
West Bengal	Land revenue; cesses on land revenue (road and public works and education cess) and agricultural income tax

Source: *Report of the Committee on Taxation of Agricultural Wealth and Income,* Ministry of Finance, Government of India, 1972, pp. 118-65.

2. For a historical review of the evaluation of Indian agricultural taxation, see Titus 1983: Ch. 3.
3. The elimination of intermediaries from the agricultural sector was achieved through a combination of legislative and legal actions after independence. For details, see Merillat 1970: Chs. 3 and 6.
4. At present, land revenue is a flat rate per hectare tax. The basis of assessment and the tax rate vary from state to state. For details see Committee on Taxation of Agricultural Wealth and Income, 1972, pp. 121-165.
5. In its report (1972), the Committee noted that available data on collections under the head of "land revenue" are deficient in that they do not reflect correctly the revenue from taxation of agricultural land. The items covered under this head are not, in fact, the same in all states. In some states (as in Gujarat), collection of cesses which go to local bodies are not always included, while in others they are. Again, in some states (e.g. Andhra Pradesh and some areas of Rajasthan), land revenue includes a compounded element of water rates, though generally water rates are charged separately. In the case of crop cesses, the collections are sometimes shown as part of the revenue from sales or trade taxes. On the other hand, collections from various miscellaneous items, which cannot strictly come within the category of land revenue, are shown under this head (*Report of the Committee on Taxation of Agricultural Wealth and Income* 1972: 5).
6. For details, see Joshi et al. 1968: 219-224.

REVENUE SHARE OF AGRICULTURAL TAXES

A summary of the revenue performance of the direct agricultural taxes during the Plan Periods is provided in Table 2. The percentage share of land revenue in states' tax revenue was 20.14 in the First Five-Year Plan Period and decreased to 17.76, 12.86, 6.73, 4.30, and 3.40 during subsequent Plan Periods. The share of total direct agricultural taxes in the tax revenue of states declined from 21.66 in the first Plan Period to 19.40, 13.98, 7.50, 4.80, and 2.61 during the following Periods. Total direct agricultural taxes constituted 14.86, 12.58, 8.68, 4.57, 3.08, and 2.61 % of the total revenue of the states during the same Periods.

On the expenditure side, agricultural taxes made up for 14.6 % of the total expenditure of states in the First Plan Period and declined to 12.88, 8.72, 4.50, 3.06, and 2.84 during the subsequent Plan Periods. Direct agricultural taxes were 1.54 % of the net domestic product from agriculture during the First Five-Year Plan Period, and it increased to 1.72 in the Second Five-Year Plan Period. It has been declining during the rest of the Plan Periods.

I have analyzed and explained the major economic and non-economic reasons for the declining share of agricultural taxes elsewhere.[7] Therefore, only brief references to these factors are given here. The major weakness of Indian agricultural taxation is its inelasticity. Because of its very nature, the flat rate land revenue cannot respond to productivity and income changes to generate additional revenue. The central government is unable to formulate and implement a uniform progressive income tax – combining agricultural and non-agricultural incomes – due to the constitutional provision of entrusting the state governments with agricultural taxation. The state governments are unable or unwilling to consider effective agricultural tax reforms because of the influence of rural power groups at the state and local levels. The major components of these power groups are wealthy farmers and rural politicians. They are effective in formulating favorable fiscal policy measures to enhance their economic and political power. Thus, it can be concluded that low levels of agricultural taxation, characterized by income inelasticity and long periods between reassessment of the base for taxation, have failed to mobilize part of this increased productivity and income for the country's developmental and modernization efforts.

Table 2
Agricultural taxes during the Plan Periods

Period	% share of land revenue in States' tax revenue	% share of total direct agricultural taxes in tax revenue of States	% share of total direct agricultural taxes in total revenue of States	% share of agricultural taxes in States' total expenditure	direct agricultural taxes as a % of NDP from agriculture
First Five-Year Plan (1951-52 to 1955-56)	20.14	21.66	14.86	14.60	1.54
Second Five-Year Plan (1956-57 to 1960-61)	17.76	19.40	12.58	12.88	1.72
Third Five-Year Plan (1961-62 to 1965-66)	12.86	13.98	8.68	8.72	1.54
Annual Plan Periods (1966-67 to 1968-69)	6.73	7.50	4.57	4.50	0.85
Fourth Five-Year Plan (1969-70 to 1973-74)	4.30	4.80	3.08	3.06	0.69
Fifth Five-Year Plan (1974-75 to 1978-79)	3.40	4.16	2.61	2.84	0.82

Sources: *Report on Currency and Finance*, Reserve Bank of India, various issues.
Reserve Bank of India Bulletin, various issues.

POLICY RECOMMENDATIONS

A realistic starting point for agricultural tax reform considerations should be the realization that agricultural tax reforms alone cannot solve all the problems of rural India. The relevance of such tax reforms is that they are only part of a broader scheme of equity-oriented rural development policies. Thus, the commitment of Indian political decision makers to agrarians and rural development efforts should be the major ingredient of agricultural tax reforms. If a certain minimum level of political support for agricultural tax reforms can be expected from the political decision makers, the next step is the formulation of viable tax reform proposals. Instead of proposing the perfect agricultural tax for India, I am simply outlining policy considerations which could function as basic guidelines for the state governments if and when they attempt to reform the agricultural tax structure.[8]

A modified land revenue which will include the following features seems to be a viable alternative for the near future. These features are:

1. Exemption of the poorest 50 to 60% of the farmers from land revenue payments. As these poorest farmers own only 7 to 10% of the land, this exemption will not affect the revenue collection substantially. On the other hand, if effectively mobilized, they can be an asset to the government in resisting the traditional rural power structure.

2. The existing flat rate land revenue[9] should be replaced by a progressive land revenue system. The progressive rate structure should be based on: (a) the size of the land holding and (b) changes in productivity, prices and incomes.

The two components of the modified land revenue system should be the assessed market value[10] of the land

7. For a cross section analysis of the income elasticity of the major state taxes of 15 states, see Titus 1983: Ch.4. For a detailed discussion of the major political economy constraints on Indian agricultural tax reforms, see Titus 1982.

8. In my recent paper (1982), I have argued that such a commitment to equity-oriented rural development policies themselves may be necessary for the survival of the existing socio-political system (pp. 61-62).

9. The Committee on Taxation of Agricultural Wealth and Income points out, "The major defect of the present land revenue system is that land revenue is assessed at a flat rate per hectare and hence is not progressive. In a village, a landholder owning, say, 10 hectares of land pays only 10 times the land revenue paid by a landholder who owns only one hectare"(1972: 24).

10. In determining the market value of the land, adjustments should be made to eliminate the increases in the land value especially due to speculative land transactions or due to the unusually high rate of inflation.

plus the estimated net income[11] derived from the land. The assessed value of the land provides the base for the tax on the current market value of the major assets of the farmer. The estimated net income provides the base for the taxation of changing productivity and income. The combination of these two base components should provide reasonable estimates of the farmer's ability to pay taxes. Considering the differences in the political and economic ideologies of the state governments and their willingness to implement progressive agricultural tax reforms, it is meaningless for me to proceed further to construct a single progressive rate structure. Therefore I suggest that working out the details of the rate structure should be left to the individual state governments.

3. For the next few years, assessments in every 5-year period seem to be reasonably workable intervals. While there is no sanctity attached to the 5-year intervals, assessments within shorter periods may be difficult due to manpower limitations and due to the delays in obtaining necessary price and productivity data. Using 5-year averages will also eliminate the year-to-year productivity and price fluctuations. Lastly, land revenue estimates, if reliable, can be used in formulating agricultural development programs under the Five-Year Plans. Thus, the revenue needed for a particular Five-Year Plan can be incorporated into the assessment and rate determination process for that period.

4. The single most important policy consideration regarding agricultural tax reforms in India should be that expenditures for agricultural and rural development must be associated with agricultural taxation. The negative incentive effects of the increased taxation on agricultural production can be minimized by reinvesting these revenues for the development of agriculture.[12] The resistance to tax increases can also be minimized by providing increased expenditure benefits to the farmers.

Fiscal policy can be used to change the direction of agricultural and rural development. Accomplishing this change in the direction of agricultural and rural development depends not only on increased agricultural taxation, but also on the allocation of the revenue for proper investments. As the tax-expenditure policies of the past decades have benefited the middle and upper income farmers, the major emphasis of the fiscal reforms should be increased benefits to and participation of the rural poor. Thus, the agricultural policy of "growth-with-development" centers around increasing agricultural production and reducing unemployment, poverty, and inequalities in rural areas.[13] Achievement of these goals at least partially depends on the reorientation of the investment priorities from the expenditure side of the budgets. As Donnelly points out,

> . . . Rural development strategy must be designed to reorient investment flows, agricultural research and technological innovations, as well as the many supportive government policies and programs in the agricultural sector – a reorientation from the large scale, capital intensive, highly commercialized sub-sector toward small-scale, labor intensive subsistence farms (1979:10).

Thus, discontinuing the tax subsidy policies which benefit a minority of wealthy farmers and reorienting these policies for the benefit of the majority of the rural poor must be an integral part of the new rural development strategy.

The policy options outlined above deserve favorable consideration from the central and state governments for a number of reasons. First, implementation of these policies is possible within the existing constitutional framework. Second, administrative problems of assessment of land, productivity, income, etc. can be minimized by utilizing and, if necessary, retraining the existing land revenue personnel. Finally, further delays in improving the economic and social conditions of the 50 to 60% of the rural poor will itself undermine the stability of the political and social system. Even though agricultural tax-expenditure policies alone cannot solve all the problems of India, if used properly they can be effective instruments of economic development and modernization of rural India.

CONCLUSION

The share of agricultural taxation in the revenue sector of India has been declining significantly during the past few decades. Transforming agricultural taxation from a colonial agricultural surplus mobilization tool into an effective instrument of rural development and modernization requires strong policy measures from the political decision makers. If needed political support is forthcoming for agricultural tax reforms, a modified progressive land revenue incorporating the assessed market value and 5-year average income from the land holding may be a viable alternative to the existing systems of agricultural taxation. It is only by allocating this revenue from land taxation for investments which create agricultural growth and which benefit the rural poor that tax-expenditure policies become meaningful for "growth-with-development" strategies.

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11. The net agricultural income can be obtained by deducting the cost of cultivation from the gross agricultural income. As the cost of cultivation varies from state to state and even within a particular state, the details of the cost calculations should be left to the state governments. The state agriculture departments should work with the district and village officers to determine the cost conditions of the particular areas.

12. The essence of my argument here is that agricultural tax increases, if offset by higher levels of governmental expenditure for agricultural development, may minimize the negative incentive effects on agricultural production. Two major conclusions of Gandhi's study provide additional support to this argument. Gandhi observes that there is a positive and significant correlation between per hectare government expenditure and per hectare agricultural productivity. Regarding the scope for increasing agricultural taxation, Gandhi suggests that the effect of land tax on agricultural productivity is statistically insignificant and concludes, "marginal upward revisions in the levels of land revenue may not seriously affect agricultural production" (1970: 169).

13. For detailed discussions on these types of agricultural and rural development strategies, see Donnelly 1979; Mellor 1976.

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APPENDIX

Public sector outlay during the Plans

(Rupees in millions)

Sectors	*First Five-Year Plan (1951-52 to 1955-56)*	*Second Five-Year Plan (1956-57 to 1960-61)*	*Third Five-Year Plan (1961-62 to 1965-66)*	*Annual Plan Periods (1966-67 to 1968-69)*	*Fourth Five-Year Plan (1969-70 to 1974-75)*	*Fifth Five-Year Plan (1975-76 to 1979-80)*
Agriculture and allied sectors	2900 (14.8)	5490 (11.7)	10890 (12.7)	11670 (17.3)	23200 (14.7)	47660 (12.1)
Irrigation and flood control	4340 (22.2)	4300 (9.2)	6650 (7.8)	4570 (6.8)	13540 (8.6)	34340 (8.7)
Power	1490 (7.6)	4520 (9.7)	12520 (14.6)	11820 (17.5)	29320 (18.6)	70160 (17.9)
Village and small industries	420 (2.1)	1870 (4.0)	2360 (2.8)	1440 (2.1)	2430 (1.5)	5100 (1.3)
Industry and minerals	550 (2.8)	9380 (20.1)	17260 (20.1)	15750 (23.2)	28640 (18.2)	96910 (24.6)
Transport and communications	5180 (26.4)	12610 (27.0)	21120 (24.6)	12390 (18.3)	30800 (19.5)	69170 (17.6)
Others	4720 (24.1)	8550 (18.3)	14930 (17.4)	9920 (14.7)	29860 (18.9)	69880 (17.8)
Total	19600 (100.0)	46720 (100.0)	85730 (100.0)	67560 (100.0)	157790 (100.0)	393220 (100.0)

Source: Reserve Bank of India Bulletin (1970: 1105) and Report on Currency and Finance (1980-81: 96-97).
Note: Figures for the Fifth Five-Year Plan are plan outlay and the rest of the figures are actual amounts.

COLOMBIA:

Revision of Government Decrees

by M.A.Gª Caballero

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SALES TAX

STAMP DUTIES

INTRODUCTION

Some time ago the Government issued a number of decrees with a view to introducing significant tax amendments.[1] These decrees were promulgated under the provisions concerning the state of (economic) emergency and required the approval of the Supreme Court of Justice which had to check whether they did not violate the Colombian Constitution. The Supreme Court found that the decrees in a number of cases did not conform to the Constitution and recommended revision which was accepted by the Legislature which promulgated Law 9/83 of 15 June 1983 containing the definitive text of the current provisions. The most significant departures from the earlier decrees which were introduced by Law 9/1983 relate, among other things, to income tax, complementary net wealth tax, complementary tax on remittances abroad, inheritance tax, sales tax and stamp duties, all pertaining to the taxable year 1983 and subsequent years. These changes are briefly described below with the idea of clarifying the taxation applicable in 1983.

INCOME TAXES

Individual income tax

Tax rates

The highest rate of individual income tax (49%) will apply to income in excess of 6,550,000 pesos (US$ 1 = 83.4 pesos – 30 September 1983) instead of 7,370,000 pesos. There is a further provision that if income exceeds 6,550,000 pesos, the income tax on such income will be 44.2% of 6,550,000 pesos (2,893,478 pesos) plus 49% on the excess amount. The individual income tax table is 23 pages long and ranges from 1 peso to 6,550,000 pesos. Extracts from the table are given in Table I.

Table I

Annual income in pesos	Tax due in pesos
2,000	0
300,000	35,825
500,000	78,588
1,000,000	243,933
2,000,000	680,358
3,000,000	1,158,878
4,000,000	1,643,978
5,000,000	2,133,978
6,000,000	2,623,978
over 6,550,000	2,983,478 + 49% on income over 6,550,000

Income tax rate applicable to non-resident foreign individuals

The State Council (Consejo de Estado) decided on 23 April 1982 that Colombian-source income derived by a non-resident foreign individual (a shareholder of a Colombian corporation in the case concerned) who does not have a resident representative (which is only required in case of carrying on permanent business activities in the country) is subject to income tax at the rate of 40%; where such an individual does have a resident representative, the Colombian-source income is subject to income tax at progressive rates.

Presumptive income

For the taxable year 1983, a taxpayer's presumed taxable income is the higher of the two following amounts: (i) at least 6% of 1982 taxable net wealth, or (ii) 1.5% of 1983 receipts. However, those receipts which are not considered to be income or capital gains are not taken into account. For the taxable year 1984, such percentages will be 7% and 2% respectively.

Tax credits

Resident taxpayers may credit the amount indicated in Table II against their income tax liability (but not against their complementary net wealth tax and capital gains tax), provided that all these credits added together do not exceed their basic income tax liability.

Prepayment of the tax

Individual taxpayers other than employees[2] must pay during 1983 70% of the income tax and complementary

1. This article should be read in conjunction with the author's article: "Colombia: Tax Amendments for 1983", in 37 *Bulletin for international fiscal documentation* 5 (1983) at 232.
2. Earned income was declared exempt for purposes of this prepayment by decision of the Supreme Court of Justice of 12 April 1983, against Decree-Law 398/83 which subjected earned income to such a prepayment.

Table II

Type of credit	Amount of credit (in pesos or in %)
(i) for family circumstances:	
taxpayer	3,600
dependent spouse	3,600
each minor or handicapped child	1,800
(ii) for education, medical and hospital costs	10%
(iii) for employment	25% of the first 39,000 pesos withheld plus 10% of the excess
(iv) as employer	0.25% of the duly made payments of and tax withheld on salaries
(v) as tenant	20% of the first 98,000 pesos dwelling rent plus 5% of the excess
(v) for gifts to qualifying beneficiaries	20%, limited to 20% of the tax liability
(vii) for dividends:	
– from open corporations	20% of the first 200,000 pesos plus 10% of the excess or (if this his higher) the amount resulting from applying to the gross dividend the tax rate corresponding to taxpayer's taxable income which may not exceed 34.1%
– from closed corporations	20% of the first 200,000 pesos plus 10% of the excess
(viii) for "profits"	
– from qualifying stock funds and investment funds	treated as dividends from open corporations if such funds have maintained during the fiscal year at least 80% of their investments in shares of open corporations (see vii)
– from other stock funds and investment funds	20% of the first 200,000 plus 10% of the excess
– for interest from deposit and savings accounts if taxpayer's net wealth does not exceed 7,900,000 pesos	20% of the first 200,000 pesos
(ix) for foreign tax	100% of the foreign tax but not more than the Colombian tax due on foreign-source income

net wealth tax due for the taxable year 1982 or, optionally, 70% of the average income and complementary net wealth tax due for the taxable years 1981 and 1982 together. The amount of the compulsory prepayment in the case of new taxpayers for 1982 is reduced to 25%.

Complementary net wealth tax
(impuesto complementario de patrimonio)

The complementary net wealth tax is levied together with and as a complement to the individual income tax. The taxable persons are resident and non-resident individuals. Resident Colombians are required to file the 1983 income tax and complementary net wealth tax returns if their 1983 gross income exceeds 200,000 pesos or their gross wealth (including property outside of Colombia) at 31 December 1983 exceeds 540,000 pesos. Resident foreigners and undivided inheritances of foreign decedents who were resident in Colombia are required to file the 1983 income tax and complementary net wealth tax returns if their 1983 gross income or gross wealth (including property outside of Colombia but only after the fifth year of residence in the country) exceeds such amounts. Non-resident foreigners without a resident representative are only required to file the 1983 complementary net wealth tax return if the gross value of the property situated in Colombia exceeds 540,000 pesos on 31 December 1983. Exempt property for complementary net wealth tax purposes is public debt bonds and mortgage bonds issued before 30 September 1974, participations in mutual investment funds and the first 1,800,000 pesos of new investments in domestic publishing companies of a scientific and cultural character.

The net wealth tax table is 11 pages long and ranges from 1 peso to 51,200,000 pesos. Extracts from the table are given in Table III.

Table III

Annual net wealth in pesos	Tax due in pesos
400,000	0
5,000,000	52,141
10,000,000	138,274
20,000,000	327,780
30,000,000	517,780
40,000,000	707,780
50,000,000	897,780
over 51,200,000	920,580 + 1.8% on net wealth over 51,200,000

Withholding taxes

The rates of withholding taxes on certain income items paid to resident and non-resident taxpayers have been established as follows:

(a) **For residents** (note that these taxes are advance payments on account of the final income tax due, against they may be credited).

(i) *individuals: earned income* is subject to withholding tax at progressive rates from 4.4% to 33.8% (maximum rate if monthly earned income exceeds 300,000); *dividends from closed corporations* are subject to withholding tax at progressive rates from 1.37% to 35.3% (maximum rate if monthly dividends exceed 300,000 pesos); *dividends from "open" corporations* are subject to withholding tax at the rate of 2% (on a monthly dividend between 170,001 and 300,000 pesos) and at the rate of 5% if the monthly dividend exceeds 300,000 pesos; *income from bearer securities* (other than mortgage and public bonds) paid to unidentified taxpayers is subject to withholding tax at the rate of 40%; *interest* (less than 80 pesos per day is not subject to withholding) is subject to withholding tax at the rate of 5%, unless the interest is exempt; *royalties, commissions, fees and similar payments* are subject to withholding tax at the rate of 3%; lottery and similar prizes are subject to 10% withholding tax. Copyright royalties are exempt up to 360,000 pesos for each copyright item.

(ii) *companies: for dividends*, 3.6% of each accrual where paid to corporations or similar companies (i.e. stock-issuing partnership, State and partly State-owned companies) and 2% of profit, where paid to limited companies and similar companies (i.e. general partnerships, simple limited partnerships, mining companies, business associations and private foundations); *for interest*, unless exempt, 5%; *for royalties, commissions, fees and similar payments*, 5% where paid to corporations or similar companies and 3% where paid to limited liability and similar companies; *for lottery and similar prizes*, 10%.

(b) **For non-residents** (note that these taxes are imposed on *gross* payments and that the tax is final, i.e. the payment of the income tax is deemed to have been satisfied by the withholding of tax).

The effective rates of withholding tax applicable to non-resident individuals and foreign companies are as follows:

- *dividends:* 40% (a preferential rate of 20% is available, where the country of which the foreign company is a national taxes dividends at a rate of 28% or more);
- *profits derived from participations in limited liability companies and similar companies:* 40%;
- *non-exempted interest, commission fees, remuneration for personal services and royalties in general:* 40%;
- *movie royalties:* 24% (i.e. 40% of 60% of gross payment);
- *fees for computer programming:* 32% (i.e. 40% of 80% of gross payment);
- *other payments:* 14%.

In addition to the above-mentioned taxes withheld, complementary tax on remittances abroad is imposed or the gross amount of remittances of profits (with the exception of dividends and exempt interest) to a person abroad.

- *branch profits;*
- *profits distributed by a subsidiary* other than a joint stock corporation: 12%;
- *interest, commission and other fees, rentals for leasing, know-how and technical assistance; fees and royalties* in general: 12%;
- *movie royalties:* 7.2% (i.e. 12% of 60% of gross payment);
- *fees for computer programming:* 9.6% (i.e. 12% of 80% of gross payment);
- *other payments:* 1%;
- *exempt income:* dividends, interest on short term loans to finance imports and on banking overdrafts; interest on export financing; interest on foreign trade credits paid to Colombian finance companies; interest on foreign trade credits paid to banks and finance corporations; interest paid by companies carrying on business in the sectors of energy, aqueducts, drainage, telecommunications, public health, education, mining, and exploration and exploitation of hydrocarbons and interest on loans to public companies. Note: In the case of interest, no withholding tax is applicable. The tax base on which the complementary tax on remittances is levied is gross payment less the withholding tax at source which was previously deducted from income (with the exception of branch profits which are not subject to withholding tax).

Company income tax

Tax rates

The company tax is levied on income and capital gains at the rates in Table IV.

Table IV

Type of company	*Tax rate (in %)*
Corporations, stock-issuing company, "de facto" companies similar to these, public and partly State-owned companies, foreign-owned subsidiaries and branches of foreign companies	40
Limited liability companies, general partnerships, simple limited partnerships, mining companies, "de facto" companies similar to these, organized community-property, business associations and private foundations	18

"Open" corporations

"Open" (publicly held) corporations[3] must meet a new requirement, i.e. shares representing at least 4% of their paid-in capital must have been traded on the Stock Exchange in the preceding year and such trading must have taken place at least 12 times in the year concerned.

Tax credits

The credits which may be offset against and up to the amount of the basic tax liability corresponding to the type of business organization adopted by the taxpayer are shown in Table V.

3. See for the definition of "open corporation", 37 *Bulletin for international fiscal documentation* 5 (1983) at 233.

Table V

	Type of credit	Eligible company	Amount of credit	Limitation of credit	Credit requirements
(i)	On dividends (from corporations and similar companies)	Corporations and similar companies*	36%	30% of taxable base	———
		Insurance, credit and finance companies	Id.	Id.	must distribute, unless otherwise authorized, more than 60% of profits in the same fiscal year
		Ltd. liability and similar companies	16.2%	tax liability	profits must be imputed to their identified partners
(ii)	On profits (from Ltd. liability and similar companies)	Ltd. liability and similar companies	16.2%	tax liability	profits must be imputed to their identified partners
		Corporations and similar companies	14.4%	30% of taxable base	must distribute more than 60% of such profits
(iii)	Special credits	Colombian air transport companies	100%	tax liability	the total tax liability must be invested in their business operations or 50% thereof in Latin American air transport companies in the same fiscal year
		Colombian majority-owned corporations	8%	tax liability	at least 51% of the capital must be held directly or indirectly by Colombians
(iv)	On investments	Forestry and agricultural firms	100% of the new investments	10% of taxable base	———
(v)	On capitalizations	Open corporations	15% of new capital increase	15% of tax liability	at least 51% of the nominal capital increase must be held directly or indirectly by Colombians
		Closed corporations	8% of new capital increase	8% of tax liability	———
(vi)	On export certificates (CAT)	Export corporations and similar companies	40% of CAT value	tax liability	———
		Other export companies	20% of CAT value	tax liability	———
(vii)	On gifts	Corporations and similar companies	45% of gifts	20% of tax liability	must be given to public entities, or to qualifying non-profit associations or foundations with exclusive activities of health, education, culture or scientific and technological research
		Other companies	20% of gifts	Id.	Id.
(viii)	On foreign tax	Any company	100%	Colombian tax due on foreign-source income	———
(ix)	On withholding	Any company	0.25% of duly made and paid withholding		———

* Where dividends are received by so-called family corporations (i.e. corporations controlled by persons linked through consanguinity or marriage), to qualify for this credit, more than 60% of the profits must be distributed during the same fiscal year.

Taxation of inheritances, bequests and gifts

With the abolition of the tax on successions,[4] inheritances, bequests and gifts transferred as of 4 February 1983 are now subject to capital gains tax (impuesto a la ganancia ocasional) in the hands of the heirs and beneficiaries. This tax is complementary to and paid simultaneously with the income tax and is assessed on the portion effectively received by each heir or beneficiary.

In calculating the taxable base, the first 980,000 pesos received by the spouse and/or legitimate ascendant/descendant of Colombian and foreign decedents resident in Colombia are exempt from tax; in all other cases, the taxable base is equal to 80% of the portion transferred to each heir or beneficiary.

The capital gains tax on inheritances, bequests and gifts is levied at the following rates:

- For Colombians and resident foreigners: 50% of the individual income tax rate applicable to their taxable bracket, minimum 10%.
- For non-resident foreigners, for any type of foreign company and for resident corporations and similar companies: 40%.
- For resident limited liability and similar companies: 18%.

An advance payment of this must be made in the case of gratuitous transfers in cash and is equal to:

- for spouse and legitimate ascendant/descendant/heirs: 5% of the effective portion received (excluding the first 980,000 pesos);
  for other heirs and beneficiaries: 5% of 80% of the effective portion received.

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4. See 37 *Bulletin for international fiscal documentation* 5 (1983) at 232.

SALES TAX

Law 9/83 grants the Government extraordinary authority to introduce amendments to the sales tax by decree under the following conditions:

- the rates may be changed, provided that the minimum rate is not lower than 6% (was 4%) and that the maximum rate is not higher than 35% (unchanged). Petroleum derivates may not be taxed at a rate higher than 4%, domestically manufactured motorcars for the transportation of passengers (other than taxis) are subject to rates of 25% and 30%, respectively, depending on engine capacity (cc.);
- the scope of the tax may be extended to include new items and taxpayers who were hitherto not subject to sales tax (provided that these items or taxpayers were not exempt).

STAMP DUTIES

Two new types of stamp duty have been introduced: the visa duty and the consular invoice duty.

The *visa duty* is imposed on foreigners applying for a visa (exempt if they are entitled to a diplomatic, official or courtesy visa). The tax is levied in fixed amounts expressed in U.S. dollars:

- transit visa: $ 10;
- student and tourist visa: $ 20;
- temporary ordinary visa: $ 30;
- temporary business visa: $ 150.

The consular invoice duty is levied at the rate of 1.2% of the f.o.b. value of merchandise exported as stated on the invoice.

HONG KONG:

Tax Treatment of Patent Rights, Etc.

By Cameron G. Greaves

Mr. Cameron G. Greaves is a resident partner of the Hong Kong branch of Deloitte Haskins & Sells, Certified Public Accountants.

The Hong Kong Inland Revenue Ordinance has been amended to include a section – to be numbered Section 16E – under which expenditure incurred in connection with the purchase of patent rights or the rights to any trade mark or design may be deducted for tax purposes provided that the trade mark or design will be used in the production of income which will be chargeable to tax.

This amendment has a certain significance inasmuch as:

(1) previous deductions in respect of patent rights, etc. were limited to registration costs (Section 16(1)(g)) as opposed to "capital" costs;
(2) the deduction is mandatory;
(3) the new section provides for the deduction to be prorated where the item acquired is used partially in Hong Kong and partially overseas; and
(4) any subsequent sale of rights in respect of which a deduction was allowed is fully taxable.

Care will have to be exercised regarding the timing of deductions relating to patent rights, etc. (hereinafter called know-how) acquisitions having regard to provisions (2) and (3) above.

Assume, for example, that company A, which prepares its financial statements on a calendar year basis, acquires know-how relating to the manufacture of certain special items on 30 December 1983. It is further assumed that on 31 December 1983 A, having taken delivery of such know-how and put into operation, manufactures a small quantity – say that one day's production is 500 items – which is held in inventory on 31 December 1983. This means that the manufacturing would have commenced immediately and an element – albeit a small element – of A's closing inventory would have been completed by the end of the accounting year. As this inventory would have been used to reduce the value of costs of sales for the accounting year, the value of the goods would be included in the income chargeable to tax; and thus under new Section 16E(1) such expenditure will be fully deductible for 1983/84 (Hong Kong's financial year runs from 1 April to 31 March)[1] since all the use to which the know-how was put was in connection with income arising in Hong Kong. The following year might see no production in Hong Kong with all the use of the know-how being undertaken at a branch office located in an overseas territory where, for whatever reason, no tax was payable. It would appear that no adjustment may be made concerning the deductibility.

Conversely, if the roles were reversed with the initial production being undertaken outside Hong Kong and the 1984 (calendar year) manufacturing being executed within Hong Kong, there would be no deduction available for the purposes of Hong Kong profits tax.

The significance of the foregoing from an overall point of view is that the new section clearly seeks only to permit a deduction based upon the circumstances prevailing in the year of assessment in which the expenditure is incurred. Hitherto, deductions have been permitted provided that the expenditure was incurred in the production of chargeable income for *any* period, i.e. preceding or following. Clearly Section 16E seeks to rise above the general deductions section (Section 16) in this particular regard.

The question of sales proceeds is one which is comparatively simple to analyse, setting aside any territorial considerations which may arise. The basic premise is that if the original acquisition price was deductible, then the entire proceeds of sale are treated as trading receipts and are fully chargeable.

The question of allocation also arises. If a company which purchases know-how and, during the year of acquisition, utilises such know-how in the manufacture of items both in Hong Kong and outside, then only part of the expenditure will be deductible. The basis of allocation is not set out in the legislation (Section 16E(2)) and it is presumed that either the total items manufactured using the know-how or, possibly, the total items manufactured using the know-how and sold during the year will be used as the denominator of a fraction to be applied against the total expenditure. The numerator of the fraction will be the amount of items either manufactured or manufactured and sold in Hong Kong. Once again, the proportion of sales proceeds to be brought into the charge to profits tax will be the same fraction as was used when determining deductibility as applied to the sale.

Know-how expenditure incurred prior to the date upon which the amendment became effective (the year of assessment 1982/83) is unaffected and know-how sales which take place during 1982/83 and subsequent years will not be chargeable provided no deduction was granted and the sale is not brought into charge by any other section of the Inland Revenue Ordinance.

The amendment will undoubtedly cause some interpretational problems particularly in the area of the deductibility clause which contains such words as "reasonable and appropriate". How these will come to be resolved is a matter for the future to determine.

1. In accordance with the provisions of the Inland Revenue Ordinance, an organization which regularly makes up its financial accounts to a date other than 31 March is permitted to use its regular accounting date for the purposes of establishing what is known as a basis period for the fiscal year. The fiscal year is known as the year of assessment. The date which can be used by non-31 March accounts preparers is the accounting date which ends within the basis period for the year of assessment. From this it follows that the accounts for the year ended 31 December 1983 will form the basis period for the year of assessment 1983/84. Similarly the accounts for the year ended 31 December 1982 form the basis period for the year of assessment 1982/83, and so on.

IFA news

BRITISH BRANCH

1985 Congress in London

The 1985 IFA Congress will be held 8-13 September 1985 at the Barbican Centre for Arts and Conferences. This modern development, which was opened by Her Majesty The Queen in 1982, has excellent facilities and also provides a home for the London Symphony Orchestra and the Royal Shakespeare Company.

The Barbican is set in an historic area of the City of London – one of the best preserved sections of the City's Roman Wall is within the Barbican Complex. The adjoining Museum of London illustrates daily life in London from earliest times.

Within walking distance of the Barbican Centre are the River Thames, St. Paul's Cathedral, the Tower of London and Tower Bridge.

The provisional programme is as follows:

Subject I: Problems concerning the assessment and collection of tax from non-residents.
Subject II: International double taxation of inheritances and gifts.
Seminar A: International tax problems of tax-exempt organisations and funds.
Seminar B: Taxation of international financial markets.

Sunday	afternoon & evening	Registration at the Barbican Centre and Welcome party
Monday	morning	Opening Ceremony Buffet lunch
	afternoon	Subject I: panel and discussion
	evening	Reception by Her Majesty's Government at the British Museum
Tuesday	morning	Subject I: continuation of panel and discussion
	afternoon	Subject II: panel and discussion
	evening	Concert and theatre evening
Wednesday	morning	Subject II: continuation of panel and discussion
	afternoon	Seminar A
	evening	Free
Thursday	All day	Excursions for delegates and their accompanying guests in London and the surrounding countryside
	evening	Free
Friday	morning	Seminar B
	afternoon	Closing session and General Assembly
	evening	Gala evening.

The Congress Patron is H.R.H. The Duke of Edinburgh, K.G., K.T.

The organizing committee has the following members: President: David Davidson – Secretary: John Hickman – Treasurer: John Phillips – Members: John Reynolds and Hugh Roe.

The Secretariat is:
Conference Associates IFA
34 Stanford Road, London W8 5PZ, United Kingdom
Telephone: 01-937 3163

SWISS BRANCH

Report on activities in 1982

The Swiss Branch sent a report on its activities of 1982 which are hereafter summarized.

The Branch's officers met several times, on 4 February, 24 June and 4 November 1982. During the general assembly of 25 June 1982, the Chairman, Dr. K. Amonn, resigned as did 6 other officers, Messrs. Cl. Brélaz, Ch. Constantin, Dr. P. Gmür, Prof. Dr. E. Höhn, Dr. K. Locher and Dr. M. Lusser. On the same date, Mr. M.B. Ludwig was elected as the new Chairman, Mr. J.M. Rivier became Vice-Chairman, Dr. K. Stocker Honorary Treasurer and Dr. H.K. Lüscher Honorary Secretary. The other officers elected were Dr. J. Béguelin, Prof. Dr. P. Böckli, Dr. A. Burckhardt, Mr. J.P. Chapuis, Dr. H. Gunz, and Prof. Dr. F. Zuppinger.

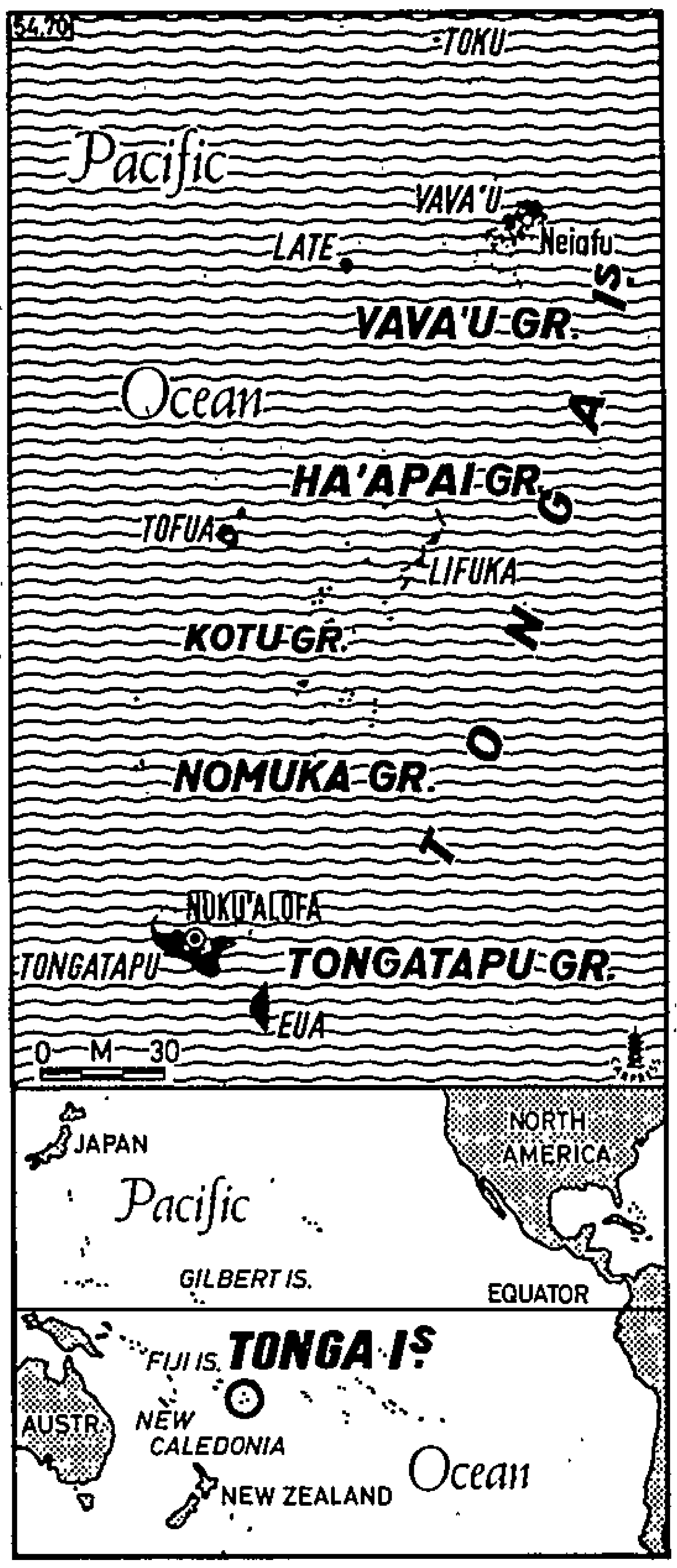
Messrs. Ludwig and Rivier will represent the Swiss Branch in the General Council but may be replaced by one of the following gentlemen: Dr. Lüscher, Dr. Stocker, Dr. Burkhardt or Dr. Gunz.

By the end of 1982 the Swiss Branch had 270 individual and 70 corporate members, an increase of 21 over 1981.

At the meeting of 5 February 1982 in Basel, the proposed tax harmonization of Swiss federal and cantonal taxes was discussed. In this respect Prof. Dr. E Höhn and Miss D. Yersin dealt with the taxation of families, Dr. Th. Husy and Mr. K. Sewer discussed problems concerning taxable periods, Mr. J.B. Paschoud and Dr. A. Suter took the taxation of capital gains on movable property as their subject of discussion and Dr. M. Reich and Mr. W. Pfäffli spoke about special subjects concerning the taxation of legal entities (especially holding and domiciliary companies).

The meeting of 25 June 1982 in Zürich was in particular dedicated to the subject of Switzerland as a financial center. Dr. F.H. Vögeli, Mr. C. Caflisch and Dr. C. Stockar spoke on the tax aspects of international competition for Swiss banks.

During the meetiong of 5 November 1982 in Basel, Dr. A.R. Schmid and Mr. Rivier reported on the 1982 Montreal Congress and afterwards the reports for the 1983 Venice Congress were discussed. Mr. Béguelin reported on the tax treaty negotiations between France and Switzerland.



The Tax System of the Kingdom of Tonga

A Brief Survey

By Eugen Jehle

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I. INTRODUCTION

(a) General information[1]

The Kingdom of Tonga is a constitutional monarchy which comprises some 169 islands situated in the South Pacific. Tonga, which is often referred to as the "Friendly Islands", is a member of the British Commonwealth; moreover, it is a member of various organizations and signatory to agreements of economic significance, including the Asian Development Bank, the South Pacific Economic Commission, the Lomé Convention and the SPARTECA Agreement.

Tonga has about 96,000 inhabitants who live on some 36 of the islands. The land area of Tonga is about 700 km^2 which is scattered over an ocean area of some 259,000 km^2. The capital of Tonga is Nuku'alofa.

The legislative authority (also for tax matters) is the Parliament which consists of the Speaker, members of the Cabinet, 7 nobles, and 7 commoners who are elected by popular vote.

(b) Fields of industrial and commercial interest in Tonga[2]

The Kingdom of Tonga offers investment opportunities of particular interest to both domestic and foreign investors in the following fields:

- *manufacturing industries,* especially timber production and processing; coconut oil production; production of saddles, soccer and rugby balls;
- *agriculture,* especially cattle and poultry raising; production of fruits such as vanilla beans, watermelons and pineapples; horticultural activities as regards root crops and vegetables;
- *tourism,* especially the construction of hotel and motel facilities; the arrangement of yacht and cruise operations;
- *fishery.*

Foreign investment in these fields is particularly welcome if the following requirements are complied with:[3]

- processing of local resources;
- contribution to local value added;
- access to managerial, marketing skills;
- transferring appropriate technology and expertise;
- are manpower intensive;
- have export potential;
- offer import substitution;

Mr. Jehle is senior research associate of the International Bureau of Fiscal Documentation.

1. For an English language survey containing general information on Tonga, see: J. Carter (ed.), *Pacific Islands Year Book,* Pacific Publications, Sydney and New York.
2. The following brochures provide further information on investment possibilities in Tonga:
- Industrial Investment Guide, Kingdom of Tonga;
- Investment in Tonga;

both released by the Ministry of Labour, Commerce and Industries (MLCI). More information on investment opportunities in Tonga is, inter alia, available from:
- Ministry of Labour, Commerce and Industries (MLCI)
P.O. Box 110 – Nuku'alofa
Tonga Islands (South Pacific)
Telephone 21 888; Telex: GENTEL TS.; Cable: MINLAB TONGA
- Tonga Development Bank
P.O. Box 126 – Nuku'alofa
Tonga Islands (South Pacific)
Telephone: 21 333

3. The Industrial Development Incentives Act of 1978.

- involve local equity participation (joint ventures are normally preferred;
- provide a base for ancillary industries;
- bring complementary benefits to other manufacturers or producers.

(c) The structure of Tonga's State revenue

In generating revenue for the budget, Tonga relies to a great extent on import duties and the port and service tax (which, in fact, has very much the character of an import duty too); see specific sections below. The figures in Table I represent the major sources of revenue for the past 4 years, indicating the actual amount of revenue generated and the percentage share of the total revenue.[4]

Table I – Major sources of revenue

	1977/78	%	1978/79	%	1979/30	%	1980/81	%
Import dues	2,983,530	34	2,795,927	32	3,297,307	32	3,845,072	31
Income tax	1,065,711	12	1,154,513	13	1,505,966	14	1,658,067	13
Port and service tax	1,620,412	18	1,790,129	20	2,156,435	20	2,934,303	23
wharfage	261,428	3	260,006	3	247,836	2	257,400	2
Philatelic revenue	266,429	2	140,354	2	234,257	2	—	—
Interest	91,890	1	—	—	—	—	—	—
Fisheries	—	—	180,835	2	—	—	—	—
Telephone rentals	—	—	—	—	220,796	2	343,442	3
Sale of stamps	—	—	—	—	—	—	275,028	2
	6,289,400	70	6,321,764	72	7,662,597	72	9,313,312	74

II. THE DIFFERENT TAXES OF TONGA[5]

As briefly indicated above, Tonga's revenue is, to a great extent, derived from indirect taxes/duties upon the importation of commodities. Nevertheless, the significance of direct taxes, particularly the company income tax and the individual income tax,[6] is expected to increase in the years to come as the Government's efforts to develop further industrial and commercial activities in the Kingdom materialize.

It may be noted that at present (1 October 1983), the Kingdom of Tonga is not party to any treaty for the avoidance of double taxation. Double taxation is avoided or mitigated in Tonga through unilateral relief measures, applying a tax credit system.

(a) The company income tax[7]

(i) The general rule

A company is defined as any corporate body or any partnership that consists of 7 partners or more; it is regarded as resident if it is incorporated in Tonga or has its centre of administrative management there.

Taxable income comprises 8 different categories in case of resident companies and 9 in case of non-resident companies. A number of exemptions is provided for, mainly concerning charitable bodies and public enterprises serving the general interest.

Taxation takes place on a yearly basis and is based on that amount of income that is determined in deducting from gross income all deductible expenses. Expenses that are not deductible include expenditure that does not occur in the production of the business income, capital expenditure, bad debts which have not been proved bad to the satisfaction of the Commissioner, payments made to the spouse, the amount of income tax itself, and any other payments (rent, interest, etc.), which do not occur in the context of deriving income.

Trading stock is generally valued at cost price but the Commissioner may approve a method that deviates from this principle.

The rate of the company income tax is fixed as follows:

- residents : 25% on first T$100,000
  35% on the excess.
- non-residents : 37.5% on first T$50,000
  42.5% on the excess.

Where a company makes payments of a certain type, there is the obligation to deduct withholding tax in the following cases:

Type of payment	Rate applicable for payments to residents	– non-residents
dividends	5%	15%
interest	5%	15%
royalties	5%	15%
rents (i.e. lease of Tonga-sited land)	5%	5%

As a general rule, companies are obliged to file a tax return within 2 months after the end of the fiscal year.

(ii) Taxation of insurance companies[8]

Resident insurance companies are taxed according to the general rule. However, non-resident insurance companies deriving insurance premiums from Tonga (other than life insurance) are taxed on the gross amount of those premiums. The rate is fixed at 2.5 seniti (T$1 = 100 seniti) for every T$1 of premium paid.

(iii) Taxation of air and shipping transport companies[9]

Resident shipping and air transport companies are taxed according to the general rule. However, non-resident shipping and air transport companies are taxed on the gross amount of revenue. The rate is fixed at 1.25 seniti for every T$1 of revenue received.

(b) The individual income tax[10]

Individuals who are resident (i.e. have a home in Tonga) are subject to the Tongan individual income tax on their

4. Source: Report of the Minister of Finance for the year 1981, delivered by the Minister of Finance on 22 Septembe 1982.
5. The author would like to express his sincere thanks to Mr. Paul G. Spicer, Deputy Commissioner of Inland Revenue, Ministry of Finance, Nuku'alofa, Kingdom of Tonga, for his comments on the draft and the furnishing of relevant materials.
6. It should be noted that the company income tax and the individual income tax are governed by a single act, namely The Income Tax Act, 1976 (Act 17 of 1976),, as amended, the latest amendment being the Income Tax (Amendment) Act 1983, which entered into force on 1 July 1983.
7. See note 6.
8. The Income Tax Act, 1976, Sec. 27.
9. The Income Tax Act, 1976, Sec. 28.
10. The Income Tax Act 1976, Sec. 4(b).

world-wide income, whereas non-residents (i.e. no home in Tonga) are subject to tax only on their Tonga-source income.

The taxable income comprises 8 different categories in case of resident persons and 9 in case of non-resident persons.

A number of exemptions is provided for, mainly concerning the income of the King, pensions under the Pensions Act, income of life insurance companies to the extent that they represent previously paid premiums, and certain travelling and subsistence allowances.

Of particular interest is, of course, employment income. In the case of resident persons, it includes all salaries and wages.[11] Non-resident persons are subject to tax on all salaries and wages that are earned in the Kingdom of Tonga; it is not relevant whether or not the principal or employer is a resident of Tonga.

Capital gains derived by either resident or non-resident individuals are not subject to income tax (unless they occur in the category of business and professional income).

The fiscal year (i.e. assessment year) runs from 1 July until 30 June.

In determining the applicable tax rate, the number of dependents the taxpayer has to support is taken into consideration. A basic exempt amount of T$1,200 is provided; above that amount a progressive tax rate is applied which runs from 5% on the lowest income bracket to 40% on the highest income bracket (without dependents). As from 1 July 1983, the rates in Table II apply.

Table II – Rates of individual income tax

Annual income	*category*	*Number of dependents of the taxpayer* 0 %	1 %	2 %	3 %	4 %	5 %
first $1,200	I	0	0	0	0	0	0
next $ 400	II	5	5	5	5	5	5
next $1,000	III	10	9	8	7	6	5
next $1,000	IV	15	14	13	12	11	10
next $1,000	V	20	19	18	17	16	15
next $1,000	VI	25	24	23	22	21	20
next $1,000	VII	30	29	28	27	26	25
next $1,000	VIII	35	34	33	32	31	30
any amount in excess	IX	40	39	38	37	36	35

Based upon the rates of Table II, the tax table (as listed in Table III) is calculated.

Please note that in case of employment income, taxation usually takes place at source with the employer deducting the tax from the amount of the employee's salary/wage. For withholding tax obligations established for other categories of income, see above.

(c) The petroleum income tax

The petroleum income tax is based on legislation of 21 August 1969 (Act 4 of 1969) which imposes a tax on in-

Table III – Amounts of tax due

Annual chargeable income of the taxpayer (T$)	*Amount of tax in T$ (in case of x dependents)* 0	1	2	3	4	5 and more
1,000	0	0	0	0	0	0
2,000	60	56	52	48	44	40
3,000	180	166	152	138	124	110
4,000	350	326	302	278	254	230
5,000	570	536	502	468	434	400
6,000	840	796	752	708	664	620
7,000	1160	1106	1052	998	944	890
8,000	1530	1466	1402	1338	1274	1210

come derived from the winning of petroleum in Tonga and its continental shelf.

At present, the petroleum income tax is of minor importance and is mentioned here merely for the sake of completeness.

(d) Stamp duties[12]

Tonga levies stamp duties on a number of documents, including signed invoices, bills of lading, bills of exchange, promissory notes, orders upon the treasury, lease or agreement for a lease for any land and/or buildings, conveyance or transfer documents, and documents concerning mortgages, bonds, debentures, covenants. The amount of the stamp duty depends on the type of document involved; it usually varies between T$0.02 and T$1.00.

(e) Company registration duty[13]

Company registration duty falls due upon the registration of a company, the filing or registering of any document, the inspection of certain documents, the certification of any copy document, etc. The basic fee for a company with share capital of up to T$5,000 is T$10, subject to increase in case of higher share capital. For other types of registration, the duty is usually between T$1 and T$2.

(f) The airport tax[14]

Tonga levies an airport tax of T$5 for each departing passenger.

(g) Customs duties[15]

Tonga charges customs duties on many import items and a few export products. The underlying legislation is grouped in 3 Schedules: Schedule I concerning import duties, Schedule III pertinent exemptions, and Schedule II export duties.

11. The Income Tax Act 1976, Sec. 15(1)(b).
12. Chapter 91, the Stamp Act (Act No. 25 of 1974).
13. Rule 18/3 of Schedule to Sec. 24 – Company Rules in Chapter 112 of Law of 23 April 1918 RR. 32/29, as amended.
14. Airport Tax Law.
15. The Customs Duties Act 1974 (Act 26 of 1974), as amended.

(i) Import duties

Schedule I makes a distinction between (a) the general tariff and (b) the Commonwealth preference tariff. By way of Act 18 of 1975, EEC countries are deemed to belong to the Commonwealth for Tonga customs duty purposes, and therefore imports from those countries benefit from the preferential Commonwealth tariff.

The tariff and statistical classifications broadly follow those of the Brussels Tariff Nomenclature (BTN) and the Standard International Trade Classification, as revised (SITC, revised).

The rates vary widely, from 0 to 45%, whereby, very broadly speaking, the preferential rates are about half the general tariff. Some tariffs refer to quantities rather than values.

The exemptions and concessions provided in Schedule III concern imports for the Government, public bodies, etc. Exempt items must be classified in detail upon importation.

(ii) Export duties

Schedule II provides for the levy of an export duty for a rather small number of items, including:

item	*tariff*
– mares	$4.00 each
– coconut; desiccated and whole	10%
– bananas	5s per case
– plantain	5s per case
– copra	10%
– numismatic coins, gold and silver	2.5%

It should be noted that Tonga is a signatory to both the Lomé Convention and the SPARTECA Agreement, and thus enjoys the privilege of having preferential access (i.e. no import duties for most items) to the markets of the EEC member countries and those of Australia and New Zealand, respectively.

(h) The port and service tax[16]

This tax can be characterized as a turnover tax levied upon the importation of *any* commodities, i.e. it does not matter whether such commodities are subject to customs duties or not.

Some exemptions are provided, including articles imported for the reigning monarch; most books; publications and documents; coins and government notes; most educational, scientific and cultural materials; fertilizer; goods imported for transfer to third countries; newspapers and periodicals; certain personal luggage; and ship's ballast.

Exemption is also granted for certain items if they are of British Commonwealth origin (and, since 1975, if they originate in an EEC country; see (g) above), including: butter; cement; certain insecticides or fungicides; margarine; agricultural machinery and implements and component parts thereof; certain other machinery; timber; water pumps, pumping plants, pipes and fittings and tanks.

The port and service tax is levied on the value of goods imported in accordance with the Customs Duties Act.

The tax is levied at the rate of 5%.

III. TAX INCENTIVES FOR INVESTMENT IN TONGA

In order to develop its economy along the lines mentioned in Section I of this article, Tonga offers a number of tax incentives.[17]

The ultimate range of tax incentives to be granted to an enterprise is decided by the Ministry of Labour, Commerce and Industries and will be noted in the "development licence" which is issued upon approval of an investment application. it may include, at the distribution of the Ministry, the following:

(a) an income tax holiday for up to 5 years (in exceptional cases a longer period may possibly be granted);
(b) an exemption from the withholding tax on dividends for up to 5 years (number of years corresponds with that of (a); dividends must not be received later than 2 years after the end of the tax holiday period);
(c) the depreciation allowances can be "saved" for the time of the tax holiday, i.e. commencement of depreciation after expiration of the tax holiday;
(d) customs duties may not be charged upon the importation of plant, equipment, machinery or spare parts for 2 years;
(e) the port and service tax may be lowered to half the normally applicable rate;
(f) refund of (import) customs duties and the port and service tax charged for new materials that are exported after being processed, etc., in Tonga;
(g) exemption from customs duties and the port and service tax for new materials used on trial;
(h) an unlimited – in terms of time and amount – carry forward of losses.

Instead of the tax holiday mentioned under (a) above, a permanent exemption may be granted if the investment takes place in an industry that is new to Tonga.[18]

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16. Chapter 95, The Act to impose a Port and Service Tax (Act 5 of 1940, Act 10 of 1944, Act 5 of 1946, Act 10 of 1950, Act 9 of 1954).
17. The Industrial Development Incentives Act 1978 (Act 5 of 1978). The Tourist Act 1976 (Act 19 of 1976).
18. Income Tax (Amendment) Act 1983, Sec. 3(2).

UNITED STATES:

Offshore Tax Havens and Tax Treaty Countries

Opening statement of Mr. Roscoe L. Egger, Jr., Commissioner of Internal Revenue, before the Commerce, Consumer and Monetary Affairs Subcommittee of the House Government Operations Committee, 13 April 1983 (extracts)

. . .

Overview of the problem

Before discussing in detail the problems we face and our responses to them, let me take a moment to briefly explain how we define tax havens.

"Tax havens" have been loosely defined to include countries having a low or zero rate of tax on all or certain categories of income and offering a high level of banking or commercial secrecy. Most tax havens also possess modern communications systems. A general lack of current controls, and an aggressive policy of self-promotion.

Applied too literally, this general definition could cover many nations that are not actual tax havens and exclude others that are. However, I'm sure anyone familiar with the subject "knows one when he see one", regardless of the exact definition used. Over time those nations seeking recognition as tax havens have generally been successful in attracting the attention they sought.

In dealing with tax havens and related issues in an international setting, the Internal Revenue Service encounters numerous operational, legal, and diplomatic problems. In a general sense, however, these problems involve two major areas: the abuse of tax treaties and the abuse of financial secrecy.

The most immediate problem in both areas is accessibility to information, or rather a *lack* of accessibility. The problem here is not so much one of substantive tax law, but of getting the information to enforce it, as well as using that information effectively. The secrecy provisions of offshore tax havens create a veil which we often have great difficulty penetrating in an effective manner.

Abuse of tax treaties

The abuse of tax treaties by treaty shopping is the first major problem area facing the Service. Let me briefly explain what "treaty shopping" is and how it works to conceal income from the Service.

"Treaty shopping" is the practice of taking advantage of treaty benefits (primarily exemptions and reduced rates of tax) by individuals, corporations or other entities not entitled to these benefits. A major device for treaty shopping is the interposition of an intermediate entity, located in the treaty country, between the ultimate investor and the investment. That entity receives the income from U.S. sources in the form of dividends, interest, royalties, etc. If it qualifies as a resident of the treaty country, the intermediate entity may obtain a reduced rate or exemption from the 30% withholding tax imposed by the U.S. on gross investment income. After receipt of the payment, the intermediate entity may then pay dividends and/or interest to the ultimate investor. A nonqualifying recipient in a third country which does not have a treaty with the United States, with little or no tax being paid to the treaty country. These intermediate entities have been used to claim benefits under several U.S. tax treaties.

The Netherlands Antilles (N.A.) treaty provides a special attraction in view of the Netherlands Antilles' reputation as a tax haven. Also, the Netherlands Antilles serves as a useful conduit for payments to nonqualifying recipients in third countries, since such payments are subject to only minimal Netherlands Antilles tax. In many cases, companies are set up there strictly to claim reduced U.S. tax rates or exemptions under the N.A. treaty while incurring no real tax consequences in the Netherlands Antilles.

For example, a resident of a country with which we have no bilateral income tax treaty may wish to invest in U.S. interest bearing securities. If such an investor were to purchase U.S. debt instruments directly, he would generally be subject to a statutory U.S. tax imposed at the rate of 30% on the gross amount of his investment income. However, by forming an Antilles corporation that borrows from him the money necessary to make the proposed investment, the investor may be able to limit his total U.S. and Antilles tax on the investment income to approximately 1%, plus payment of a small management fee to an Antilles trust company.

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As you know, the Service operates a Foreign Information Reporting Program (FIRP) to match the information received from treaty partners with the information reported by taxpayers. This program, designed to enhance compliance with the information reporting requirements on amounts paid to U.S. persons by foreign sources, is the international equivalent of our Information Returns Program.

There are, however, a number of problems with this information reporting that are directly related to the complexities of international tax administration. For example, when the tax laws and regulations of other countries do not require information reporting to those countries' own tax authorities, it is extremely unlikely that our requests for information exchanges can or will be met. The same situation exists with respect to furnishing taxpayer identification numbers. Additionally, the tax return filing systems of other nations vary widely in timing and sophistication from our own, making timely, meaningful exchanges of information difficult to achieve. Another consideration is the fact that our voluntary self-assessment system of tax administration is not always known or emulated in other parts of the world.

Moreover, while existing income tax treaties provide us in excess of one million information documents a year, most of them cannot be effectively utilized in FIRP because of various deficiencies (e.g., data not for the current processing year, incomplete or illegible data, no taxpayer identification number, great multiplicity and diversity of forms, etc.) To help remedy this situation, we are establishing procedures for using experienced personnel in the screening of selected information documents for audit potential. We are also encouraging our treaty partners to utilize the "standard information document" recently adopted by the Organization for Economic Cooperation and Development (OECD).[1] As we see it, the ultimate viability of our information reporting system in this area depends on the tax treaties we negotiate with foreign governments, as well as on the extent to which those governments can or do honor the provisions of the treaties.

Abuse of financial secrecy

The second major problem area we face is that of abuse of financial secrecy. As I mentioned in my definition of tax havens, a substantial level of banking or

1. *Editor's note*: See: "O.E.C.D.: Recommendation of the Council concerning a standardized form for automatic exchanges of information under international tax agreements" in 35 *Bulletin for International Fiscal Documentation* 10 (1981) at 472.

commercial secrecy is an integral part of what constitutes a tax haven. In many cases, such secrecy has a legitimate foundation in a nation's history and law, and is usually a key factor in that nation's economic condition.

The problem, then, is not the mere existence of secrecy provisions as such, but rather the existence of unreasonably restrictive secrecy provisions, which not only encourage the commission of international tax and related crimes, but also frustrate legitimate enforcement inquiries by other nations in those cases. For the Service, this secrecy is equally troublesome in the investigation of criminal violations and the examination of legal transactions. Needless to say, unscrupulous individuals take full advantage of this secrecy to conceal income and to evade their tax obligations.

Our response to this problem has taken many forms, all of which are designed to provide us access to the information necessary for our civil and criminal responsibilities. Let me highlight a few of our major efforts for you.

Civil

The greatest problems in international examinations is the lack of easy access to information. Recognizing this, we have stepped up our liaison with other concerned nations in an attempt to increase awareness of the problem and arrive at a solution for it.

Since last June, when I recapped for the Subcommittee our international activities, a number of top Service officials have participated in the 16th annual CIAT (Center for Inter-American Tax Administrators) Assembly: the annual Group of Four (Germany, the United Kingdom, France, and the U.S.) meeting, and the annual Pacific Association of Tax Administrators (PATA) meeting. We have had a series of bilateral meetings with tax officials from Canada, Japan, Mexico, the United Kingdom, Germany, and France, and are also involved with the OECD's Committee on Fiscal Affairs' Working Party # 8, on tax evasion. (OECD consists of 21 nations, primarily in Western Europe but including Japan, Australia, and Canada as well.)

In all these meetings, non-compliance and information exchanges are constant topics of discussion. In fact, as a result of the last Group of Four meeting, we have arranged with Germany, the United Kingdom, and France to exchange information – under the existing treaties with those nations – on tax haven activities. Moreover, the German Federal Ministry of Finance will host a meeting of Examiners and Inspectors next month to discuss in detail tax haven schemes and enforcements efforts, including the simultaneous examinations I will describe shortly. We have just completed and announced an agreement with Canada to engage in simultaneous investigations of suspected tax fraud. For the next PATA meeting, in September of this year, we have proposed tax havens as a U.S. topic of discussion.

In conjunction with our treaty partners, we have also developed two major operational programs to address the information gap.

First, the Service engages in "simultaneous examinations," which are concurrent examinations of related taxpayers within our respective jurisdictions, with five treaty partners (Canada, the United Kingdom, Germany, France, and Norway) in an effort to better audit tax haven transactions. Second, "Industrywide exchanges of information" are also conducted with our treaty partners to obtain a more comprehensive understanding of selected industry practices, especially the use of tax havens. Through these industrywide exchanges with our treaty partners, the Service can identify potential cases for simultaneous examination, thereby targeting tax haven transactions. Our experience in these two areas has shown these activities to be excellent approaches to dealing with tax havens and obtaining information outside the borders of the United States.

There have been tangible results from both these programs. For example, in one case with Canada with total income adjustments of nearly $19 million, over $6.5 million was directly attributable to issues raised by the simultaneous examination technique. The industrywide exchanges of information provide direct support to these examinations through the exchange of data necessary to conduct the examination effectively.

We believe there are benefits to this examination program beyond the dollars. In particular the spirit of international cooperation that results from a well-executed simultaneous audit. Such successes often lay the groundwork for later progress in these efforts.

The U.S. has tax treaties with only a small number of countries, however, which makes it very difficult to track this international flow of funds. The movement of money does not occur in a vacuum, there are "financial fingerprints" left by those who transport these funds. Recognizing this, we have attempted to enhance use of the information reported on this flow of funds.

One of the major sources of such information is the Currency Transaction Report (CTR), IRS Form 4789. This form must be filed by financial institutions for each deposit, withdrawal, exchange of currency, or other payment or transfer by, through, or to that financial institution, which involves a transaction in currency of more than $10,000. Multiple transactions by or for any person which in any one day total more than $10,000 are to be treated as one transaction.

The information from CTR's is computer processed by the Service, forwarded to Customs for inclusion in the Treasury Enforcement Communications System (TECS), and utilized as well in our Information Returns Program (IRP) and Information Returns Selection System (IRSS).

Several initiatives are currently underway to increase our use of this information. For example, we plan to look into the feasibility of associating CTR data relating to business returns, since the current system utilizes only CTR data on individuals. We also plan to utilize the programming capability of the TCS data base to develop specific projects which can be used by agents in the field.

The staff or our Examination functions has responsibility for conducting checks of secondary financial institutions to ensure their compliance with the recordkeeping and reporting requirements of Title 31. As of 31 December 1982, 4,192 secondary financial institutions were identified by the Service, during FY 1982, we conducted 1,646 compliance checks on them.

We have also taken steps to increase the quality of information on international operations coming to the Service. Form 5471, titled "Information return with Respect to a Foreign Corporation", is a new form replacing separate forms which were previously required to be filed. The form, devised in a joint effort by the Service and the private sector, simplifies taxpayer reporting requirements. It is attached to income tax returns and will be used by the Service to identify returns for subsequent screening of their examination potential. Portions of the data reported on this form will be converted to machine sensible data which will insure that proper emphasis is placed on returns with international features, and for identifying U.S. persons with tax haven operations. The form is to be used by taxpayers filing returns in 1983.

The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 gave IRS examiners new powers to get books and records maintained in foreign jurisdictions. New Code section 982 provides that if a taxpayer fails to "substantially comply" with a "formal document request" to substantiate the tax treatment of any item, any court having jurisdiction of a civil proceeding in which that tax treatment is that issue shall prohibit, upon the government's motion, the introduction into evidence by the taxpayer of any "foreign-based documentation" covered by such a request, unless certain subsequent conditions are met. This sanction of non-admissability should increase IRS access to documents necessary to examine foreign-related transactions.

TEFRA also changed international reporting requirements by adding new Code section 6038A, which required information returns from corporations not previously obligated to report. Domestic corporations, as well as foreign corporations engaged in U.S.trade or business which are controlled by foreign persons, are now required to file information returns concerning their transactions with members of the same controlled corporate group. The information so reported should provide our examiners with sufficient data to analyze transactions in this area. Moreover, the penalty imposed by section 6038 was revised, to improve information reporting by U.S. controlled foreign corporations.

Criminal

In addition to Examination, our Criminal Investigation function has played a major part in our efforts to address the abuses of offshore tax havens and financial secrecy.

Over the past few years, the Service has increased the emphasis given to international problems in both its special Enforcement and General Enforcement Programs. Further, we are now emphasizing better organization for targeting suspected drug financiers, promoters of fraudulent tax shelters and foreign trusts, and organized crime figures – all of whom figure prominently in offshore tax haven activities.

Between 1977 and 1982, Criminal Investigation identified 694 cases which had financial transactions involving some 90 foreign countries. Our analysis of these cases show that:

- approximately 53% showed income from legal sources (including 98 cases involving tax shelters and 35 cases involving illegal tax protesters); and about 47% showed income from illegal sources (including narcotic trafficking, money laundering, embezzling, pornography, gambling, etc.);
- 493 cases (71%) involved at least one tax haven country;
- the Bahamas, The Cayman Islands, the Netherlands Antilles, Panama, and Switzerland showed up in 85% of the instances where tax haven countries were involved;
- 133 cases (19%) were discontinued or declined, in 42 reported instances because records from foreign countries were not available. Of these 42 instances, 32 involved tax haven countries.

The Service through Criminal Investigation is also increasing its use of the information required to be reported under the Bank Secrecy Act (Title 31) in identifying Title 31 and Title 26 Violations. For example, our use of Currency Transaction Reports (CTR's), IRS Form 4789, has paid dividends through effort like the Araujo investigation, a southern California case involving a large heroin distribution organization. This was brought to our attention largely as a result of CTR's filed by a small bank near the Mexican border. This case concluded with Araujo and 16 others being convicted and sentenced on tax and other charges. Araujo's unreported income tax in this case amounted to $13 million.

The Report of International Transportation of Currency or Monetary Instruments (CMIR), Customs Form 4790, is another valuable tool under Title 31. CMIR's are required to be filed by each person who exports from the U.S. or imports to the U.S. currency or other monetary instruments in amounts exceeding $5,000. The forms are processed by Customs, and information from them is included in the Treasury Enforcement Communications System (TECS), IRS currently uses CMIR information, generally in tandem with other information, as a basis to initiate criminal investigations and as supporting evidence in investigations originating from other sources. There are criminal and forfeiture provisions for not filing or for filing false CMIR's.

We believe CMIR's will prove particularly useful in helping us track the flow of laundered money and other financial instruments back *into* the U.S. once it has gone offshore. CMIR's filed by incoming travelers will include this information, which will provide solid leads for investigations.

Joining with other Federal law enforcement agencies in investigating international criminal activities has proven extremely useful. "Operation Greenback" is a coordinated Treasury and Justice Department Financial Investigative Task Force effort to investigate possible criminal violations of Title 31, Title 26, and related charges by individuals depositing and withdrawing large amounts of currency at financial institutions in south Florida. This sort of money "laundering" is of particular concern to the IRS, since illegal income is taxable just as legal income.

Significant IRS accomplishments in Operation Greenback include:

- driving force (with Customs) in the program since 1980, currently providing two-thirds (27 special agents) of the agent force;
- the assessment of more than $112 million in taxes through jeopardy/termination assessments;
- the initiation of over 180 investigations
- prosecution recommendations against 120 individuals and corporations; and
- indictments returned on 81 of these, with 23 convictions.

We now participate in over 20 similar such efforts throughout the country.

Other especially useful aspects of Title 31 from which we are also getting results are the criminal provisions. Through them we now have a means to prosecute those who are involved with and who help others facilitate illegal activities by assisting them in handling the enormous amounts of money generated from these activities.

While the availability of CTR's and CMIR's has been useful in providing a limited paper trail, the Service has found it increasingly necessary to turn to the use of undercover agents in its investigations. We are finding that evidence secured in this manner, which would not have been obtained using traditional methods, is proving to be crucial in prosecuting some cases. In one of our cases which just became public last month, five men were indicted for allegedly using a Las Vegas casino, foreign bank accounts, and a Netherlands Antilles corporation to hide at least $16 million in illicit narcotics profits. Arrests were made in Las Vegas, Chicago, and Biloxi, Mississippi. The FBI and DEA participated with us in this investigation.

The Service through Criminal Investigation has recently initiated a task force, with participation from our Examination function and the Customs Service, to identify U.S. taxpayers who are using tax haven countries and/or offshore banks to evade U.S. taxes and to commit other related violations (such as Title 31). The task force will also focus on the extent of noncompliance in this area and the schemes and techniques used. The information developed by the task force will be analyzed and disseminated to our field offices for investigative purposes.

The passage of TEFRA also provided help to our criminal investigators. Criminal fines relating to Code sections 7201, 7203, 7206, and 7207 were increased. These involve situations where taxpayers attempt to evade or defeat tax, where they willfully fail to pay tax or keep records or report information, where they take fraudulent actions or make false statements in an attempt to evade or defeat tax, and where they file returns, statements, or documents known to be fraudulent. These new fines range between \$10,000 – \$100,000 for individuals and between \$50,000 – \$500,000 for a corporation.

New Internal Revenue Code section 6867, also from TEFRA, permits certain presumptions where an individual in possession of more than \$10,000 in cash or its equivalent denies ownership, and fails to identify a person who can be readily ascertained and who acknowledges ownership. The Service may presume that the cash represents gross income of an individual for the year of possession and that collection is in jeopardy, and take action accordingly.

TEFRA also specified that a U.S. citizen or resident not currently in the United States can be sued by the IRS in the District Court for the District of Columbia for the purpose (among other things) of enforcing a summons for testimony or documents.

International Problems: An Example

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) that you mentioned in your March 24 letter represents a good case study of these major problem areas (abuse of treaties and secrecy laws) and the difficulties in fashioning an effective response to them.

As you may know, prior to the passage of FIRPTA foreign investors in U.S. real property could in most cases dipose of their interests without being taxed on any capital gain. This situation existed in large part because under the Internal Revenue Code capital gains not effectively connected with a U.S. business generally were not subject to any U.S. income tax. This ability to avoid U.S. income tax was perceived as a stimulus to foreign investment in U.S. real estate, especially farm property, with the possibility of a corresponding increase in land prices that would work to the disadvantage of American farmers.

FIRPTA attempted to establish equity of tax treatment in U.S. real property between foreign and domestic investors by providing in Code section 897(a) that the gain or loss of a non-resident alien individual or a foreign corporation from the disposition of a U.S. real property interest should be treated as if the taxpayer were engaged in a U.S. trade or business during the taxable year, and as if such gain or loss were effectively connected with such trade or business. A U.S. real property interest was defined in such a way that foreign investors could not avoid taxation by holding real estate through a domestic or foreign corporation, partnership, or trust.

Treaty abuse ws present in the form of treaty-shopping done to find treaties which permitted foreigners to elect on an annual basis to treat rent received from U.S. property as active trade or business income. The effect of this treatment was that depreciation and other business deductions more than offset rental income, and the arrangement could be easily structured to exclude real estate capital gains from taxation when the property was sold. This has been remedied by FIRPTA.

Financial secrecy laws render it difficult to collect the FIRPTA tax, since complex organizational structures can be used to obscure foreign ownership of realty. FIRPTA's imposition of reporting requirements will require disclosure of the identity of foreign investors. Reporting can only be avoided by entering into a security agreement with the Service. Guaranteeing the payment of any FIRPTA tax that becomes due. The security agreement provisions are particularly important in that many foreign investors are willing to pay the tax but do not wish their identities disclosed.

Conclusion

Mr. Chairman, I cannot emphasize too strongly the international nature of the problems under discussion, and the corresponding need for international solutions. Unilateral approaches, even the best-intentioned and most efficient, are likely to have only limited success in this area.

Under these circumstances, I believe our continuing participation in international tax administration organizations, as wel as our functional liaison with our counterparts in other nations, are essential to any successes in combatting offshore tax havens and related abuses. These efforts represent our best chance to overcome the economic, cultural, political, and linguistic differences that separate us from even the most cooperative nations.

While we may not be able to persuade other nations to emulate our self-assessment system of taxation, we believe that in time we can encourage increased cooperation on a number of important fronts. In this way, we will eventually "close the window" on abuses in the international area.

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ZIMBABWE:

Budget 1983-84

Extracts from the Budget Speech pronounced by the Minister of Finance, Economic Planning and Development on 28 July 1983.

The Finance Bill is now in its last stage of discussion in Parliament. The editors of the *Bulletin for International Fiscal Documentation* hope to be able to publish an article on the new legislation early in 1984.

In my 1982 budget I deliberately avoided any increase in company tax because I recognised that the level was already high and I did not want to erode returns on corporate capital. It will be argued that I should follow a similar line this year but I am afraid that with so few options open to me, I cannot exempt any one group of taxpayers from making a contribution. I propose, therefore, that the existing surcharge of 15% applicable in the 1982-83 tax year be increased by 5% to 20%. This increase will be payable before 30th June, 1984 and may be spread equally over the two advance payment dates remaining in the fiscal year. Allowing for the fact that company profits in 1982-83 were generally lower than in the previous year, I expect the 5% increase in surcharge to yield \$10 million. I have not found this an easy tax to propose.

Firstly, I know that many companies are struggling at present and it may even seem contradictory to bring in a company tax that will raise \$10 million while providing, as I have already explained, \$40 million in the estimates of expenditure for assistance to industrial and mining enterprises most of which operate as companies. The fact of the matter is that the performance of some companies is relatively better than that of others and I am effecting a degree of redistribution which is justifiable in the circumstances. Secondly, the increase raises the gross nominal rate of tax on companies to 54% which is one of the highest in the world. I am fully aware that this may make investment unattractive but I trust that investors will take into account our depreciation allowances and understand the short term nature of our difficulties and take a longer and more optimistic view of the economy in which better items will return and tax rates can be reviewed.

Individual income tax payers will also have to contribute more and, here too, I propose increasing the surcharge by 5% to 20% to bring it into line with the company surcharge. This increased element must, I regret to say, be applied to 1983-84 incomes in order that the maximum yield can be obtained in this fiscal year as a contribution to drought related expenditure. There is another reason for applying the increase in this manner and that is to spread the burden on taxpayers in the P.A.Y.E. system. If the surcharge were applied to 1982-83 incomes, I would have to collect it via the assessments to be sent out during the current fiscal year which would mean that taxpayers would have to pay the whole amount due in one payment. To the extent that there might be any delay in sending out the assessments or individuals might experience difficulty in making payment, the yield would suffer. By using the P.A.Y.E system and applying the surcharge to the 1983-84 tax year I can ensure a better yield while enabling taxpayers in the system to spread the burden over 6 months from October 1983 to March 1984.

In the case of other individuals, the increased surcharge will be mainly levied as an advance surcharge at the rate of 5% on the assessments for the year ending 31st March, 1983. This advance surcharge will be credited against the individuals' assessment for the year ended 31st March, 1984, which will bear the actual surcharge of from 20% to 40%.

When the 1983-84 assessments are issued in due course, a new accelerated surcharge will apply and will, as shown in the Financial Statements, begin at 20% and end at 40%. The top marginal rate will, therefore, go up from 60% to 63%. I estimate that this proposal will yield some $18 million.

The quantum of my revenue needs in relation to the rather limited tax base is such that I cannot hope to achieve my target without resorting to further increases in the sales tax rates. I therefore propose to increase the general rate from 16% to 18%, and the rate for consumer durables from 19% to 23%. At the same time I propose increasing the range of goods subject to the higher rate by including:

Records and tapes;
Photographic films in rolls;
Alcoholic beverages including beer, cider, liqueurs, spirits and wine;
Manufactured tobacco products;
Smokers' and smoking requisites such as pipes, lighters, cigarette and cigar holders;
Perfumery, cosmetic or toilet preparations for personal use excluding toothpaste and soap;
Clothing accessories wholly or predominantly of natural furskin;
Jewellery and immitation jewellery;
Goldsmiths' and silversmiths' wares or precious metal or rolled precious metal;
Paintings and pictures;
Boats, launches, yachts and other vessels excluding commercial, fishing and passenger vessels; and
Firearms and ammunition.

These increases in sales tax rates, which will be effective from 1st August, 1983, will yield an estimated $78 million. I am aware of the regessive nature of this form of taxation but by increasing the surcharge on income taxes as I have previously described, I have tried, as far as I can, to preserve the ratio of direct to indirect taxation. Furthermore, with the lower paid in mind, the exemption of basic food items from sales tax will continue and the higher sales tax rate has been biased against luxury goods.

A major defect in our tax system is that we have a narrow base. I therefore propose to introduce a tax on persons in employment who earn more than $100 a month and who are not yet in the P.A.Y.E. system. The new tax will be calculated at 2% of taxable income and will be deducted by the employer. At the interface with the P.A.Y.E. system the monthly deduction will be 2% or the P.A.Y.E. amount whichever is the greater. Separate legislation is being prepared to implement this tax and I expect it to be brought before Parliament later in this session. I estimate that this measure, to be known as the Lower level Income Tax, will yield $9 million up to 30th June, 1984.

I next propose to impose a tax of 20% on remittances outside Zimbabwe in respect of fees for technical, administrative, management and consultancy services or amounts remitted in respect of external expenses of local branches. This measure will yield some $5 million in this financial year and should provide some incentives to have such services carried out in Zimbabwe.

Turning now to customs and excise duties, I propose to increase the customs surtax on imports by 5% to 20%. I make this proposal with some reluctance because I realise that it will increase the price of all imported goods. However, the cost of development projects of Government and parastatal bodies will be exempt from the payment of this surtax as will the very large development projects in the private sector. Imported raw materials that are used in the manufacture of goods for export will benefit from the usual drawback procedure. I estimate that this measure will yield $27 million.

I am proposing to introduce an excise duty of 15% ad valorem on passenger motor cars made in Zimbabwe, and, finally, I propose a customs duty of 15% ad valorem on imported lorries and vans whether in assembled or unassembled form. These two measures which will be effective from 29th July, 1983, will, I estimate, yield $10 million.

In a budget such as this, it is very difficult to contemplate any concessions. However, as a measure of the importance given by Government to training, I propose to introduce a training investment allowance, equal to 50% of the cost to the taxpayer of buildings constructed and new equipment purchased on or after 1st April, 1983, and used exclusively for the purpose of training employees.

Summary of the Government proposals:

The rates of individual income tax will not be increased, but the surcharge which currently runs from 15 to 33⅓% will for 1983-84 be increased and will run from 20 to 40%.

A so-called "lower level income tax" of 2% will be introduced on taxable income of employees earning more than $100 per month but are not subject to P.A.Y.E.

The rate of corporate income tax will remain at 45%, but the surcharge for 1982-83 will be increased from 15 to 20%.

A training investment deduction will be introduced of 50% of the cost to taxpayers for certain buildings constructed or altered and new equipment purchased after 1 April 1983, provided these assets are exclusively used for the purpose of training personnel.

A tax of 20% will be introduced on amounts remitted outside Zimbabwe representing fees for technical, administrative, management and consultancy services or amounts remitted representing external expenses of local branches.

It is proposed to increase the rate of sales and import tax from 16 to 18% on general goods and from 19 to 23% on higher rated goods.

A 15% excise duty will be introduced on the value of passenger motor cars made in Zimbabwe. Customs duties on imported trucks, whether assembled or not, will be 15% ad valorem.

Conference Diary

JANUARY 1984

British Branch of I.F.A.: Tax problems of foreign currency transactions (Tax workshop), London (United Kingdom), January 19 (English).

Dr. Peter Deubner Verlag GmbH: Tax beneficial investment (Exclusive seminar). Gstaad (Switzerland), January 23-27 (German).

Tax Forum International: American tax fraud and penalties, criminal and civil (Seminar). Zurich (Switzerland). January 23-24; Frankfurt (Federal Republic of Germany), January 26-27 (English).

FEBRUARY 1984

British Branch of I.F.A.: International and U.K. mergers and demergers (Tax workshop). London (United Kingdom), February 7 (English).

Business Perspectives: Singapore 1984 (8th Biennial Wheatcroft International Tax Conference) (including: unitary taxes; the tax problems of investing in developed countries; tax havens; treaty interpretation; export incentives through tax reliefs). Singapore (Republic of Singapore), February 13-15 (English).

MARCH 1984

Management Centre Europe: Leasing (including: taxation and leasing; taxation and leasing-cross-border considerations). Brussels (Belgium), March 12-15 (English).

APRIL 1984

Institut für Finanzwirtschaft und Finanzrecht: Unternehmungsbesteuerung (Business taxation) (Seminar). St. Gallen (Switzerland), April 4-6 (German).

SEPTEMBER 1984

38th Annual Congress of I.F.A.: I. Fiscal obstacles to the international flow of capital between a parent and it subsidiary. II. Social security contributions as a fiscal burden on enterprises engaged in international activities. Buenos Aires (Argentina). September 16-21 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom)

Business Perspectives, Suite 804, 1735 Eye Street, N.W., Washington, D.C. 20006 (U.S.A.).

Business Research International, 57/61 Mortimer Street, London, W1N 7TD (United Kingdom).

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).

Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41 (Federal Republic of Germany).

Tax Forum International, Sonnenbergstrasse 128, 8032 Zurich (Switzerland).

Jap Kim Siong:

Taxation in the Asian-Pacific Region
A country by country survey

Asian-Pacific Tax and Investment Research Centre
2 Nassim Road, Singapore 1025
Telephone: 235-1959 – Telex: RS50257 APTIRC
1983
144 pages
Price S$ 60

This is the first volume in what is hoped will be a long series of publications of the Asian-Pacific Tax and Investment Research Centre in Singapore. The survey was prepared on behalf of the Asian-Pacific Tax and Investment Research Centre and is based on the 8-volume loose-leaf work *Taxes and Investment in Asia and the Pacific* published by the International Bureau of Fiscal Documentation, Amsterdam, the Netherlands.

The present survey is offered as a general orientation to the tax system in each country situated in the Asian-Pacific Region. The countries and territories covered comprise Afghanistan, American Samoa, Australia, Bangladesh, Brunei, China (People's Republic), Cook Islands, Fiji, French Polynesia, Guam, Hong Kong, India, Indonesia, Iran, Japan, Korea (Republic), Macau, Malaysia, Nepal, New Caledonia, New Zealand, Pakistan, Papua New Guinea, Philippines, Singapore, Solomon Islands, Sri Lanka, Taiwan, Thailand, Trust Territory (including the Federated States of Micronesia, Palau Republic, the Marshall Islands and the Commonwealth of the Northern Mariana Islands), Western Samoa. In this respect it covers more countries and territories than *Taxes and Investment in Asia and the Pacific* at present, and is the only survey ever published in one volume on the region. The countries on which little literature is available in English have been dealt with more extensively than those countries on which more publications in English are available, e.g. Australia, Hong Kong, India, New Zealand, Philippines, Singapore etc.

The former include Afghanistan, American Samoa, China (People's Republic), Fiji, Guam, Indonesia, Iran, Japan, Korea (Republic), Macau, Nepal, New Caledonia, Papua New Guinea, French Polynesia, Taiwan (Republic of China), Thailand, Trust Territory of the Pacific Islands.

The survey per country follows a common outline to provide some basis for comparison except that on China (People's Republic), in view of the difference with respect to political philosophy concerning public ownership. The outline comprises classification of taxes and levies; an outline of taxes (corporate income tax, individual income tax); avoidances of double taxation (unilateral relief, double taxation agreements), net worth tax, sales tax, customs duties, excise duties, estate duties, gift duties; and tax incentives.

It is hoped at such time as a reprint of the survey is required that, apart from updating the existing country surveys, expansion to other countries (viz. Burma, Mongolia, Korea (People's Democratic Republic), Vietnam, Laos, Kampuchea, Kiribati, Tuvalu, Vanuatu, Nauru, Tonga, Maldives, Niue and perhaps Hawaii) will be feasible.

At present, the survey shows the author's wide use of documents from many countries and territories. It should find its place in all tax libraries of any significance, as it gives a quick informative survey. It is available to all members of the Asian-Pacific Tax and Investment Research Centre in Singapore, free of charge.

Bibliography

Books

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