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# Contents

of the January 1978 issue



**In next issues:**

Experience with Urban Land Value Taxes in Developing Countries
— by *George E. Lent*

The German Corporation Tax Reform and the revision of its double tax treaties
— by *Dr. Theodor Faist*

Large scale tax increase in Japan, the recommendation of the Tax Commission
— by *Makoto Miura*

U.S. taxation of non-resident citizens
— by *T.C. Geiser*

## UNITED KINGDOM:

# The Structure and Reform of Direct Taxation

by Prof. J.E. Meade

Summary of some of the main points made in the report of a committee of the Institute of Fiscal Studies on the "Structure and Reform of Direct Taxation". *

This report covers three main groups of topics:

### I. The Choice of Tax Base for the Main Direct Taxes (Income Tax, Capital Gains Tax, Corporation Tax)

*There are some features of the present income tax (such as the remission of tax on savings through approved pension schemes or the remission of tax on the investment of savings in those forms of capital development which enjoy 100 percent first year capital allowances) which make the tax operate as if it were a tax on consumption-expenditures rather than on income. This mixture of income base with expenditure base in the income tax, together with some similar features of the corporation tax and combined with the operation of the capital gains tax, give rise to some very anomalous situations in the capital market.*

### II. The Excessively High Marginal Rates of Tax (Actual or Implied) which Occur at Present at the Two Extremes of the Income Scale

*There rates exist not only at the top end of the income scale where rates of tax rise to 83 percent and 98 percent on earned and investment incomes respectively, but also at the lower end of the income scale where the unsystematic combination of income tax, national insurance, and means-tested benefits can give rise to implied marginal rates of tax of anything up to or even beyond 100 percent (the poverty trap).*

### III. The Most Appropriate Forms for Taxes on Capital

*Such taxes can take the form of taxes on the transfer of wealth (such as the present Capital Transfer Tax) or of taxes on the holding of wealth (such as the proposed Annual Wealth Tax).*

*The present arrangements under I and II above give rise to such anomalies that reform seems essential. In the report the basic principles of reform are presented by describing a number of alternative radical restructurings of the tax system. But the reader should not be misled by this form of presentation. The Committee stresses the need to avoid a once-for-all gigantic upheaval of the whole existing tax structure. But it is nevertheless desirable to define the basic restructuring of the tax system which might be regarded as the ultimate objective, in order to ensure that any immediate gradual step-by-step changes taken to remove existing anomalies are of a kind which lead in the right rather than in the wrong direction.*

Professor J.E. Meade chaired a committee which discussed the disadvantages of the present United Kingdom direct tax system and which also prepared a report on the structure and reform of this system. He started his career in 1930 when he became a Fellow and Lecturer in economics at Hertford College, Oxford. He was an Editor of the League of Nations' World Economic Survey in Geneva from 1938-1940. From 1940-1947 he was a member of the Economic Section of the War Cabinet Secretariat in London, serving as Director from 1946-47. In 1947 he was appointed Professor of Commerce with special reference to International Trade at the London School of Economics where he stayed until 1957. From 1957-1967 he was Professor of Political Economy at the University of Cambridge and from 1967-1974 a Senior Research Fellow at Christ's College, Cambridge. From 1974-1977 he was Chairman of the Committee on the Structure and Reform of Direct Taxation at the Institute for Fiscal Studies in London.

* This summary was published as a booklet by the Institute of Fiscal Studies. The full report is published in book form by George Allen & Unwin, hard cover £ 19.50, paperback £ 6.95. The address of the Institute of Fiscal Studies is, 62 Chandos Place, London WC 2 N 4 HG.

## I. THE TAX BASE

### The Anomalies in the Present Tax Regime

In Chapter 4 of the report an account is given of the anomalous effects of present arrangements. The yield which a saver can get on his or her savings relatively to the real yield obtainable on the capital development which is financed by those savings is naturally affected, under a progressive income tax, by the marginal rate of tax to which the saver is liable; but in addition to this the yield to the saver depends upon:

(i) the channel through which the savings are lent (e.g., pension fund, life insurance, building society, direct investment in the Stock Exchange);
(ii) whether the funds are used by a company liable to corporation tax or by an unincorporated business;
(iii) whether the funds are provided in the form of fixed interest debt or of participation in the equity of the concern;
(iv) what is the tax regime for the treatment of the depreciation of the real assets in which the funds are invested; and
(v) whether any profits made in the investment are distributed or are ploughed back into the business.

It is not generally realised how absurd are some of the results under present arrangements, where for a basic-rate taxpayer the yield on savings as a result of the tax system can vary from two fifths of the real yield on the underlying investment to no less than four times that yield. If the saver can invest through a pension fund which is exempt from tax, the range can be from a half to almost six times the yield in the underlying real investment. The capital market cannot be expected to perform its function of channelling savings in the most appropriate forms to the most productive uses without reform of this tax system.

Many of these anomalies are due to the muddle between income base and expenditure base in the present tax system. In the opinion of the committee the choice lies between a gradual shift back towards a true income base or a gradual shift still further in the direction of an expenditure base. With one exception the members of the committee would prefer a shift in the direction of an expenditure base for a number of reasons.

### The Advantages of a Tax on Expenditure

(1) A tax on expenditure shifts the burden of taxation from those who earn and save on to those who spend lavishly out of capital gains (at present taxed at a rate not exceeding 30 percent) or by living on capital funds (which at present escape tax).

(2) A tax on expenditure provides the most favourable tax background for the economic expansion of all forms of enterprise (whether private or nationalised, large or small, labour-managed or capital-managed), since all funds devoted to savings and investment are free of tax. This is especially important for small but growing private businesses where the main source of funds for capital development may have to be the personal savings of the owners.

The combination of these two features — namely, (1) the concentration of heavy taxation on high levels of consumption however financed and (2) the encouragement of business enterprise — constitutes a tax structure which has perhaps the best chance of attaining some degree of political consensus for its acceptance.

(3) An expenditure tax frees the capital market to operate effectively in the allocation of capital funds.

(4) A shift from an income base to an expenditure base makes it much easier to operate a fair and efficient tax system in inflationary conditions. The personal allowances and tax brackets in any progressive scale of tax on an individual taxpayer's consumption-expenditures would, of course, need adjustment in the light of rises in the money cost of living. But it would no longer be necessary for tax purposes (i) to distinguish between real and money capital gains, nor (ii) to devise a system of depreciation allowances which covered the real depreciation of fixed assets, nor (iii) to distinguish between changes in the money value and in the real value of business stocks, nor (iv) to make allowance for putting money aside to maintain the real value of assets which were fixed in money terms. Even if rates of inflation can be brought down to relatively low single figure levels these considerations remain important.

(5) The problem of finding a fair measure for distinction between the taxation of earned and of investment income is less acute with an expenditure tax than with an income tax.

With an expenditure tax it should ultimately be possible to achieve some important simplifcations of the tax system. Capital Gains Tax could disappear. The treatment of pension funds, trusts, and close companies would be eased, since it would be only what taxpayers took out of such funds or concerns (and not what went on inside them) which would be relevant for tax purposes.

### Alternative Forms of a Tax on Expenditure

A fully fledged expenditure tax regime could take either one of two forms:

(1) With the first of these forms, which in the report is described as a Universal Expenditure Tax (UET), each individual taxpayer's total expenditure on consumption in the course of the year would be assessed by the indirect means of adding to his income certain receipts of funds other than his income (e.g. his sales of securities) and deducting from his income certain payments other than his expenditures on consumption (e.g. purchases of securities). The resulting balance would represent his expenditure on consumption, which would then be subject to a progressive tax schedule.

It is doubtful whether a tax of this form could be operated unless some system of self-assessment for tax (such as that operated in the United States) had been previously introduced. Each taxpayer might then be required to record on his tax form not only his income for the year, but also the other specified receipts and payments of funds for addition to, or subtraction from, his taxable income.

The introduction of this form of tax would in any case involve some serious transitional problems, since it could cause considerable disturbance on the markets for capital assets (e.g. the Stock Exchange) and it would make necessary some special treatment for persons who had recently accumulated funds for the purpose of financing special consumption needs (e.g. in their retirement) and which had already been subject to income tax when they were saved.

(2) An alternative form of expenditure tax, described in the report as a Two Tier Expenditure Tax (TTET) would confine the use of the method just described to a limited number of taxpayers who would be liable to higher rates of tax and who would be required to make the appropriate additions to, and subtractions from, their taxable incomes for assessment to an expenditure tax surcharge. This surcharge would replace the excess of the existing higher rates of income tax over the existing basic rate of income tax. In fact this part of the two tier tax would operate like the old surtax except that the surcharge would be levied on the taxpayer's expenditure on consumption instead of on his income.

The present base rate of income tax would be replaced by a basic rate of tax on all consumption goods and services. This result could be achieved by remitting tax on all forms of expenditures other than for consumption purposes, either under the income tax by a gradual extension of 100 percent first year allowances against all forms of expenditure on real capital assets or else by a gradual replacement of the basic rate of income tax by a uniform and universal rate of tax on value added. In this latter case the personal tax allowances under the income tax would have to be replaced pari passu by increased child benefits and similar social benefits or tax credits, as the shift from income tax to tax on value added eroded the value of the personal tax allowances.

The merit of a TTET over a UET is that it could be introduced more gradually and with less transitional disturbance. The personal assessment of a taxpayer's consumption would be confined to a limited number of higher rate taxpayers and could probably be phased in over a period of years. The basic rate of tax could be adjusted gradually by a gradual extension of 100 percent first year capital allowances or by a gradual penny-by-penny shift from income tax to tax on value added with corresponding gradual increases in child benefits and tax credits. The disadvantage of the TTET method is that it implies the continuation of a single uniform basic rate of tax to cover all taxpayers except those at the top end of the scale who would be liable to the surcharge. It thus limits the degree of flexibility for the rate structure at the lower end of the scale.

The two tier arrangement of the TTET could, however, be introduced as a first step towards an eventual UET, which might be achieved by the gradual downward extension of the range of expenditures over which the UET method of expenditure tax would operate.

## A Flow-of-Funds Base for Corporation Tax

The Committee has examined at length the sort of reform of the Corporation Tax which, in combination with a personal tax on expenditure, might help to remove the anomalies in the capital market. The present Corporation Tax levies a charge on company profits; but these profits are assessed after 100 percent first year allowances on a large range of expenditures on investment in real capital projects. In this way the tax has already changed its nature in a large measure from a tax on true profits to a tax on a flow-of-funds basis, i.e., a tax on the excess of revenues over expenditures regardless of whether the underlying transactions are on current or capital account. The report gives reasons for the view that if the personal income tax is gradually transformed into a personal expenditure tax, it would be appropriate gradually to complete the transformation of the Corporation Tax on to a flow-of-funds base. The great merit of this change would be that, while it could continue to raise considerable revenue, the tax would be simpler to administer and also would cease to cause any divergence between the yield to the company and the real yield earned on any fresh capital developments which the company undertook. It would thus remove an important set of distortions on the capital market.

Such a change might take either of two forms:

(1) The tax might be levied on the excess of revenue from sales over expenditure on purchases in respect of all real goods and services, whether these were bought or sold on capital or current account. In the report this is called the Real (or R) basis.

(2) The tax might be levied on the excess of receipts over payments in respect of all transactions (other than with company shareholders) both for real goods and for financial services and whether on capital or current account. In the report this is called the Real plus Financial (or R + F) basis.

The Committee gives some reasons for preferring the second of these two bases. The R basis would not be suitable for financial institutions (such as banks) and its introduction could involve strain on some highly geared companies. The R + F basis would not involve these difficulties. Since total receipts must equal total payments, to tax the excess of receipts from, over payments to, everyone other than shareholders amounts in the end to the same thing as taxing the excess of payments to, over receipts from, shareholders. This would appear to be an appropriate form of tax on the privileges enjoyed by shareholders from incorporation. The tax might ultimately be administered by a simple tax on dividends paid by the company less new share capital introduced into the company; and it could be levied so as to raise considerable revenue without causing any distortions on the capital market.

## Tax Relations with Other Countries

The shift of personal tax from an income base to an expenditure base and of corporation tax from a profits base to a flow-of-funds base raises two sets of problems concerning relationships with other countries living under other tax regimes.

In the first place, with certain forms of expenditure tax there is a danger that persons will be tempted to reside in this country while they are earning and saving (thus avoiding tax on their savings under an expenditure tax regime) and to emigrate on retirement to spend their capital under a foreign income tax regime (thus avoiding tax on the consumption of their savings). This problem does not arise if the expenditure tax regime takes the form of 100 percent first year capital allowances on all forms of real investment or of a basic rate tax on value added, provided that the latter is imposed on an origin basis and not on a destination basis, i.e., provided that the tax is not remitted on exports nor imposed on imports. In these conditions, there is no special advantage in spending capital in one country rather than in another, in other cases some form of tax on the capital wealth of emigrants may be needed.

In the second place, a question arises which is particularly important in the case of a shift of Corporation Tax on to a flow-of-funds basis, about the appropriate treatment of Double Taxation Relief. Since, in the absence of special measures, on a flow-of-funds basis all investment of capital funds abroad by a resident company would earn relief from UK tax, it is questionable whether it is appropriate to give relief from UK tax also on the subsequent yield from such investment. The Committee discusses at length the different arrangements which might be made in connection with Double Taxation Relief.

The gradual transformation of the income tax and of the corporation tax on to an expenditure base and a flow-of-funds base respectively thus has great advantages. The main difficulties are probably in connection with the transitional and the international implications of the change.

### A Shift Towards a Comprehensive Income Base

The Committee also examined the possibility of a transformation in the opposite direction on to a truly comprehensive income base for personal taxation and a true profits base for corporation tax. A complete move on to a fully comprehensive income (and profits) base is more difficult than a complete move on to a true expenditure (and flow-of-funds) base. Serious difficulties arise in connection with the integration of capital gains into the income base, the inclusion of the undistributed profits of companies in the personal income base, the determination of true economic depreciation, the treatment of pensions, the treatment of trusts, and — above all in present conditions — the necessary adjustment to be made between capital and income in order to obtain a measure of true income in times of monetary inflation. The members of the committee with one exception would all in any case prefer an expenditure base to an income base; but because of the practical difficulties the Committee reaches the conclusion that it would be useless to set a full comprehensive income base, properly adjusted for inflation, as the final objective even if one preferred that base in principle to an expenditure base.

However, if one is prepared to accept a range of imperfections and above all if one is prepared to turn a blind eye to many of the effects of inflation, it is possible to increase the tax base by a number of measures such as: the discontinuation of 100 percent first year capital allowances and an attempt to limit such allowances to true economic depreciation; the taxation of the annual value of dwelling houses; the application of capital gains tax to government securities and to assets changing hands at death; the cessation of tax relief of premiums paid for life assurance policies; the taxation of the income of pension funds; and so on.

### Effects on Tax Revenue

It is probable that there would in fact be little if any loss of tax revenue from a shift of the present tax system on to a full expenditure-cum-flow-of-funds base; but the advantage of a shift in the opposite direction of the kind outlined above would be that it would expand the tax base and permit some reduction of tax rates without loss of revenue.

## II. RATES OF DIRECT TAXATION

### The Anomalies which Lead to the Poverty Trap

Serious anomalies are caused through the interaction of a number of separate and uncoordinated subsidies to, and charges on, personal incomes. The great variety of measures for the taxation or subsidisation of personal income may be classified under the four following headings:

(1) First, there is the levying of the income tax itself upon personal incomes after deduction of various personal allowances which permit a first slice of income to remain untaxed.
(2) Second, there are National Insurance Contributions which are payable by employers and employed on the wages paid to employees.
(3) Third, there is a large corpus of social security benefits which are paid without subjection to any means test but upon certain other conditions such as old age, sickness, unemployment, parenthood. In some cases these benefits are, and in some cases they are not, conditional upon past National Insurance Contributions. Although the receipt of these benefits is not subject to any special test of the means of the recipient, some of them are affected by the recipient's means in that they are subject to income tax, while others are exempt from income tax.
(4) Fourth, there is a large number of other schemes for the subsidisation of relatively low personal incomes, each of which is subjected to its own special means test, some of these schemes being of great importance quantitatively. The fact that there are marked differences in the arrangements for the testing of the recipient's other means implies that there are in fact a whole number of separate income tax systems operating simultaneously, often on the same persons and not infrequently in a somewhat inconsistent manner.

The sort of position which can result from the uncoordinated combination of these schemes may be illustrated by a two-child family where the father earned £30 a week in July 1976. He would be paying income tax and national insurance contributions, receiving family income supplementation, receiving a rent rebate, and entitled to free school meals. Each involves a separate form and different criteria. Incidentally, if the father were so exasperated by all this form-filling that he assaulted one of the officials, he would then be eligible for legal aid.

Moreover, the problem is not one simply of duplication of administration. The implied marginal tax rates (i.e., the amount deducted from an extra £1 of earnings) are cumulative. In the above case with a 35 percent basic rate of tax, a 5.75 percent national insurance contribution, and a 50 percent loss of family income supplementation, the father would find that of any increase in his earnings he would lose 90 percent under the three heads above. When possible loss of rent rebate and free school meals is added, his implied marginal rate of tax could well be more than 100 percent.

### The Design of a New Beveridge Scheme

The committee considered a wide range of schemes of reform to meet this 'poverty-trap' problem. In the report it is suggested that the best solution lies in a return to the three basic principles of the Beveridge report of 1942, namely:

(i) the payment of social security benefits to those who are unemployed, sick, retired from work or otherwise incapacitated on scales sufficient to meet the minimum needs of a single adult or of a married couple;

(ii) the payment of unconditional family allowances in respect of all children on a scale sufficient to meet their minimum needs; and

(iii) the provision of a system of means-tested benefits as a safety net to meet those infrequent occasions when for some special reason principles (i) and (ii) failed to maintain a level of income adequate to meet minimum needs.

The application of these principles in present conditions would involve the following changes:

(1) Much of the present trouble is due to the fact that the threshold at which income tax starts has not kept up with what may be regarded as the acceptable minimum standard of living as measured by the scale of Supplementary Benefit. As a result of this families may be at a standard below this acceptable minimum and yet at the same time subject to deduction of income tax. A major need is to raise tax thresholds in line with the minimum acceptable standard of living.

(2) Similarly national insurance benefits — unemployment benefit, sickness benefit, pensions — need to be raised to be brought in line with the minimum acceptable standard of living.

(3) Personal allowances which determine the threshold for the start of liability to income tax are only of full value to those whose income is as great as the tax allowance. To replace tax allowances with a social benefit confers a benefit on those with inadequate earnings as well as those with adequate earnings. The replacement of child tax allowances with cash payments of Child Benefits which is now in the process of introduction in the United Kingdom is a major feature of the New Beveridge Scheme which rests on the principle that earnings should in any case be sufficient to maintain a man and wife but that there should be social benefits for the support of children.

These three changes are all expensive. They should not, however, be regarded as extravagences invented by the Committee. The Child Benefits under (3) have already been set in motion by the present government; and any government must inevitably be concerned with the present notorious discrepancy which is developing between the Supplementary Benefit scale and the tax threshold.

There are certain changes which can help to relieve these great costs:

(1) In the report it is suggested that all social benefits other than Child Benefits should be subject to tax. It is a principle of the New Beveridge Scheme that benefits should be paid to the sick, the unemployed, and the old without special means tests; but in that case they should properly, like all other elements of income, be included in the recipient's tax base. If the main personal allowances under the income tax were brought into line with the scale of social benefits, then any one receiving such a social benefit would receive it free of tax; but the social benefit would absorb the personal tax allowance and all income over and above the social benefit would thus become liable to tax.

(2) With the replacement of child tax allowances by Child Benefits the only remaining personal tax allowances involving large amounts of revenue will be those for single adults and for married couples. Revenue could be saved by the removal of the anomaly whereby a married couple, both members of which are earning, can receive a tax allowance which is approximately two and a half times the tax allowance of a single person. This anomaly should be removed by disallowing a couple to receive simultaneously both a single person's allowance against the wife's earnings and a married man's allowance (which is about one and a half times a single person's allowance) against the rest of the family income.

A more radical modification of personal tax allowances would be to give personal allowances only against earnings. A single person with only investment income would enjoy no allowance; but social benefits would be treated as earned incomes and thus with an adequate personal allowance would be untaxed. In addition taxpayers over a certain age would be permitted to set their personal allowances against investment income as well as against earned income. In the case of married couples of working age these arrangements would mean that if only one member of a married couple were working there would be only one single person's tax allowance and not the present married man's allowance against the couple's income. A radical reform of this kind would, however, need to be accompanied by a taxable cash benefit (which in the report we called a Home Responsibility Payment) payable to those who had in their charge children or other dependants needing home care and were therefore either debarred from working or obliged to make alternative costly arrangements to meet their home responsibilities. Whether, and if so by how much, the restriction of personal allowances to be set only against earnings would increase tax revenue thus depends upon the scale and conditions of receipt of a Home Responsibility Payment.

These changes are inevitably costly. But the government is already committed to the ultimate payment of Child Benefits on a fully adequate scale and to the raising of tax thresholds to correspond at least to the supplementary benefit levels; and in present conditions any alternative government would be likely to adopt a similar approach. These reforms can, however, be achieved in stages by gradual changes in scales of payments and of tax allowances.

### The Reduction of Excessively High Rates of Marginal Tax at the Top End of the Income Scale

The elimination of property and the reduction of the excessively high implied marginal rates of tax at the lower end of the income scale (the poverty trap) are thus inevitably costly. The committee also takes the view that the absurdly high marginal rates of tax at the top end of the scale (83 percent for earned income) should also be reduced. A reasonable reduction of the marginal rate at this top end of the scale to an upper limit of, say, 70 percent could in fact be achieved at a negligible cost in revenue; indeed, if the incentive effect were at all favourable there might even be a net gain of revenue.

## III. CAPITAL TAXES

If personal direct taxes were shifted on to an expenditure base, certain changes in the taxation of capital and of income from capital would be appropriate. There are four types of reason why the tax system should properly discriminate in some way against the enjoyment and use of capital wealth.

### Some Reasons for the Taxation of Capital

First, income from property may be more permanent than income from work. Under an Income Tax regime this may be held to justify some form of surcharge on investment income or of relief on earned income. Under an expenditure tax, however, this argument for discrimination disappears.

Second, the use and enjoyment of inherited wealth may be considered a fit object for special taxation, since the luck of inheritance differs from the fruits of a man's own skill, enterprise, and effort. These considerations justify the imposition of taxes on the transfer of wealth by gift or bequest to another owner.

Third, the mere ownership of wealth — and particularly of large amounts of wealth — may itself, quite apart from any income which the wealth may yield, confer security, independence, influence, and power on the owner. This argument justifies a tax on the holding of wealth (an Annual Wealth Tax) or a surcharge on Investment Income as a rough and ready proxy for an Annual Wealth Tax.

Fourth, it may be desired to tax wealth in such a way as to redistribute ownership so as to avoid great inequalities and the high concentration of large fortunes. Capital taxes on the transfer of wealth and/or on the holding of wealth, employed for the second and third of the reasons mentioned above, may be designed and applied for the promotion of such a redistribution of ownership.

### Intregration of the Taxation of Capital Transfers into the Income Tax or the Expenditure Tax

One way of taxing transfers of capital is to incorporate such transfers into the income tax or the expenditure tax itself. Thus with a Comprehensive Income Tax gifts received could be taxed as part of the recipient's income and with an Expenditure Tax gifts made could be taxed as part of the donor's expenditure. Such an arrangement would cause the rate of tax to be adjusted progressively to the recipient's income level in the case of a Comprehensive Income Tax and to the donor's expenditure level in the case of an Expenditure Tax. The arrangement would have the great advantage of enabling the whole of the apparatus of a separate transfer tax to be dismantled, though there would have to be some averaging arrangements to avoid the unfair effects of progressive tax rates on large lump-sum receipts (under a Comprehensive Income Tax) or large lump-sum outgoing (under an Expenditure Tax). To include gifts received in the tax base for a Comprehensive Income Tax is to design a tax which is geared to the whole of the life-time resources which a taxpayer receives to dispose of as he pleases; and to include gifts made in the tax base for an Expenditure Tax is to design a tax which is geared to the whole of the life-time disposal of resources by the taxpayer.

### Taxation of Inherited Wealth

It is, however, arguable that there are other objectives which it is the proper purpose of transfer taxes to achieve. In particular one may hold the view that such taxes should be expressly designed to encourage a wide dispersal of inherited wealth and to reduce very large concentrations of such wealth. In this case an Accessions Tax which acts progressively on the cumulative amount of wealth which the recipient has received by way of gift or inheritance is to be preferred to a tax which acts progressively either on the current income of the recipient or on the current standard of consumption of the donor. Moreover it may be considered desirable to adjust the impact of a transfer tax so that it falls more heavily on those who enjoyed the inherited wealth for many years than on those who enjoyed it only for a short period, a distinction which can be made by taking into account the ages of donor and of donee. For reasons of this kind the majority of the committee's members would prefer a separate form of transfer tax rather than incorporating gifts received into the base of an income tax or gifts made into the base of an expenditure tax.

Vith these considerations in mind the Committee xamined the possibility of a tax on capital transfers vhich, like an Accessions Tax, would be progressively elated to the total amount of wealth which the beneiciary had received up to date, but which would also be elated to the future period for which the beneficiary vas going to hold on to the newly acquired wealth. This atter feature would be ensured by levying a tax on the ift equal to the present value of a progressive annual vealth tax on his holding of the wealth up to, say, his 30th birthday. There would then be a repayment of tax o him if in fact he handed this wealth on to some other beneficiary before his 80th birthday, this repayment of ax being restricted to the then present value of the nnual wealth tax on his holding of the wealth for the emaining limited period up to his 80th birthday. By his means recipients of gifts and bequests would in ffect pay in advance a progressive rate of annual wealth ax on all wealth received by way of gift or bequest just or so long as they failed to hand the wealth on.

The administration of such a tax, which may be called a Progressive Annual Wealth Accessions Tax (or PAWAT), would raise a number of problems which are discussed in the report, though in the Committee's view he application of the tax should not be impossible. The ax could, however, be applied in a non-progressive (i.e. proportionate or linear) form in which case it might be called a Linear Annual Wealth Accessions Tax (a LAWAT). In this case the rate of annual wealth tax which the recipient paid in advance on receipt of a gift would be at a single rate for all gifts and would not depend progressively on the amount of wealth received. The tax would, however, be adjusted in the same way as with PAWAT to reflect the period for which the recipient of the wealth held it and failed to pass it on. This would mean that the rate of tax levied on the receipt of a gift would depend only upon the ages of the donor and of the donee; and the tax would in this form be considerably easier to apply than in its progressive form.

## The Case for an Annual Wealth Tax

The absence from LAWAT of any degree of progression of tax according to the total wealth received by the donee would in the view of the committee be a fatal objection unless this tax were accompanied by a progressive Annual Wealth Tax. Such a tax has a number of important merits.

In the first place, it is the most effective form of tax for encouraging the prompt handing on of large properties in a dispersed manner to recipients who do not own large properties; for whether the wealth be inherited or accumulated out of his own savings by the existing owner it will incur a high tax liability each year so long as it is held in a concentrated form, a tax burden which will be reduced as soon as the wealth is dispersed.

In the second place, changes in the rates of tax, which will almost certainly take place from time to time with changes in economic and political conditions, are less arbitrary in their incidence in the case of an Annual Wealth Tax than in the case of a tax on transfers of wealth. In the former case changes of tax rates affect, so long as they last, all owners of wealth equally. In the latter case they fall with exceptional weight or exceptional levity on those owners who chance (by reason of death or otherwise) to make their transfers at dates when tax rates happen to be exceptionally high or exceptionally low.

## Some Problems on an Annual Wealth Tax

But an Annual Wealth Tax has its own drawbacks.

First, there are many practical difficulties, in particular the difficulties of valuation and the problems of finding an appropriate treatment of pension rights. To include such rights in the taxpayer's wealth presents great difficulty; but to treat the taxpayer who has no appreciable pension rights as being no less wealthy than the man whose pension expectations may we worth over £100,000 may be considered a grave injustice.

Second, there is clearly some clash of objectives in a tax structure which combines an expenditure tax with an annual wealth tax. A main purpose of an expenditure tax is to allow all savings and capital development to go tax free and to levy tax progressively on what is spent on consumption. But the existence of an annual wealth tax will mean that as soon as wealth has been accumulated or inherited on a scale sufficient to exceed the threshold for the annual wealth tax, any additional savings will in fact be subject to this annual tax just so long as they are not either given away or dissipated in riotous living. It is impossible to avoid some such clash if one wants to encourage savings and discourage dissavings and at the same time to tax the advantages of holding wealth and to encourage its dispersal. The only question which can arise relates to the balance between the two objectives and the two taxes. Clearly the combination of an expenditure tax and an annual wealth tax is preferable from this point of view to the combination of an income tax and an annual wealth tax. With the former combination one can provide through the wealth tax a given tax on holding wealth and a given incentive to disperse wealth with a much smaller disincentive to saving and capital development than with the latter combination. Moreover, if the threshold for the wealth tax is reasonably high one can give an unadulterated incentive and opportunity for business development up to the point at which the business concerned has grown sufficiently in size to increase appreciably its ability to raise outside capital; and it is not unreasonable to design the tax on the principle that it is only fairly large concentrations of wealth that bring with them great power and influence and which the tax system should be designed to disperse.

## Two Alternative Treatments of Capital Taxes

As a result of these considerations the committee considered two possibilities: first, a combination of a progressive expenditure tax plus a PAWAT with a rather severe tax structure designed to tax heavily large concentrations of inherited wealth but without an Annual Wealth Tax: and, second, a progressive expenditure tax plus a LAWAT to give a general discrimination against inherited wealth plus an Annual Wealth Tax with a high threshold, but with a fairly steeply progressive tax schedule above that threshold, to effect the main incentive for the dispersal of the ownership of the property.

The former of these combinations would avoid the many very real difficulties and disadvantages of an Annual Wealth Tax, but it would mean that there was no tax on the holding of wealth accumulated out of the owner's own savings and it would involve some troublesome, but in the Committee's view not insuperable, problems in the administration of PAWAT.

The latter combination would be less favourable then the former to saving, enterprise, and capital development beyond the threshold for the Annual Wealth Tax and would involve the very real difficulties both of administration and of equity in the operation of an Annual Wealth Tax. But it would operate as a more prompt and a more direct tax incentive for the dispersal of large fortunes; and since tax rates are likely to be changed from time to time, it would provide a form of capital tax which was less arbitrary than PAWAT in its incidence.

### Conclusions

The committee expresses the hope that the combination of New Beveridge (to set an acceptable floor to the standard of living of all citizens), of a progressive expenditure tax regime (to combine encouragement to enterprise with the taxation of high levels of personal consumption), and of a system of progressive taxation on wealth with some discrimination against inherited wealth presents a set of final objectives for the structure of direct taxation in the UK which might command a wide consensus of political approval and which could be approached by a series of piecemeal tax changes over the coming decade.

# An annual net worth tax in France? Yes - if the left wins the elections

Two of France's left wing parties, the Socialist Party and the Radicals of the Left, have recently submitted bills to the French Parliament requesting the introduction of an annual net worth tax on both individuals and companies. [1] This tax will — if adopted — be in addition to the capital gains tax introduced in 1977, since the Left Parties are not satisfied with the imposition of the capital gains tax alone.

### Personal net wealth

With respect to personal wealth, the left wing parties consider that currently the owners of substantial wealth often remain untaxed, because such property is unproductive, as may be the case with real property which is also exempt from capital gains tax if it has been held long enough by the owner (30 years in case of building sites (terrains à bâtir) and 20 years in all other cases).
One would perhaps expect that the proposals would aim at a drastic reduction in the wealth of the rich, thus reducing social inequalities. However, the Bill proposes to exempt wealth up to a value of 2 million francs per family unit (e.g. husband and wife). In addition, business property will only be taken into account for that part of its value which exceeds 500,000 francs. The proposed rate is graduated as follows:

| *Taxable value in Fr.Frs. (above 2 million)* | *Rate* |
|---|---|
| The first 500,000 | 0.5% |
| The next 2.5 million | 1 % |
| The next 2.5 million | 1.5% |
| The remainder (in excess of 10 million Fr.Frs.) | 2 % |

### Corporate net worth

The taxable base will be the balance of the value of the company's assets over its liabilities. The rate will be 1 percent on the first 1 million francs of taxable net worth and 1.5 percent on the remainder. The tax will not be deductible for purposes of the corporate income tax.

1. Bill for the introduction of a tax on substantial personal wealth (Proposition de loi tendant à instituer un impôt sur les grandes fortunes, Document No. 3408 of the Assemblée Nationale of December 16, 1977) and Bill for the introduction of a tax on corporate capital (Proposition de loi tendant à instituer un impôt sur le capital des sociétés, Document No. 3450 of the Assemblée Nationale of December 21, 1977).

# CONFERENCE DIARY

## EBRUARY 1978

*British Branch of I.F.A.:* Stamp duties (including corporate reorganizations and EEC equirements), London (U.K.), February 2 (English).

*British Branch of I.F.A.:* Tax workshop: Taxation of profits from European oil and gas, London (U.K.), February 22 (English).

## MARCH 1978

*British Branch of I.F.A.:* Tax workshop: Tax developments in the EEC, London (U.K.), March 16 (English).

*20th CIAT Technical Conference* (Inter-American Centre of Tax Administrators): Principal Problems in Tax Collection, Buenos Aires (Argentina), March 27 – April 1 (English, Spanish).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Copenhagen (Denmark), March 20-22 (English).

## APRIL 1978

*British Branch of I.F.A.:* The Meade Report, London (U.K.), April 5 (English).

*Business International Institute:* International Seminar (including International Taxation Theory, Transfer Pricing etc.). Port Chester (N.Y., U.S.A.), April 17-28 (English).

*Management Centre Europe:* The growing pressure on international tax management, Zurich (Switzerland), April 19-21 (English, French and German).

*Management Centre Europe:* Tax management in a multinational environment (Seminar), Brussels (Belgium), April 4-5 (English).

*Seminar Services International:* The 8th "Multi-Choice" International Tax Planning Symposium. Part 1 (Introductory Course) – April 12, 1978; Part 2 (Multi-Choice advanced seminars) April 13 and 14, 1978. Zurich (Switzerland) (English, French and German).

## MAY 1978

*British Branch of I.F.A.:* Anglo-U.S. Seminar, London (U.K.), May 4 and 5 (English).

## JUNE 1978

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), June 19-21 (English).

## SEPTEMBER 1978

*32nd Annual Congress of I.F.A.:* I. The Taxation of Extractive Industries; II. The Differences in the Tax Treatment between Local and Foreign Investors and the Effects of International Treaties. Sydney (Australia) September 17-23 (English, French, German and Spanish).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (Seminar), Brussels (Belgium), November 7-8 (English).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian taxation. Copenhagen (Denmark) September 4-8 (English, French, German and Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Australian Branch of I.F.A.: Bank of New Zealand House, 12th Fl. 333 George Street, Sydney 2000 (Australia).

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

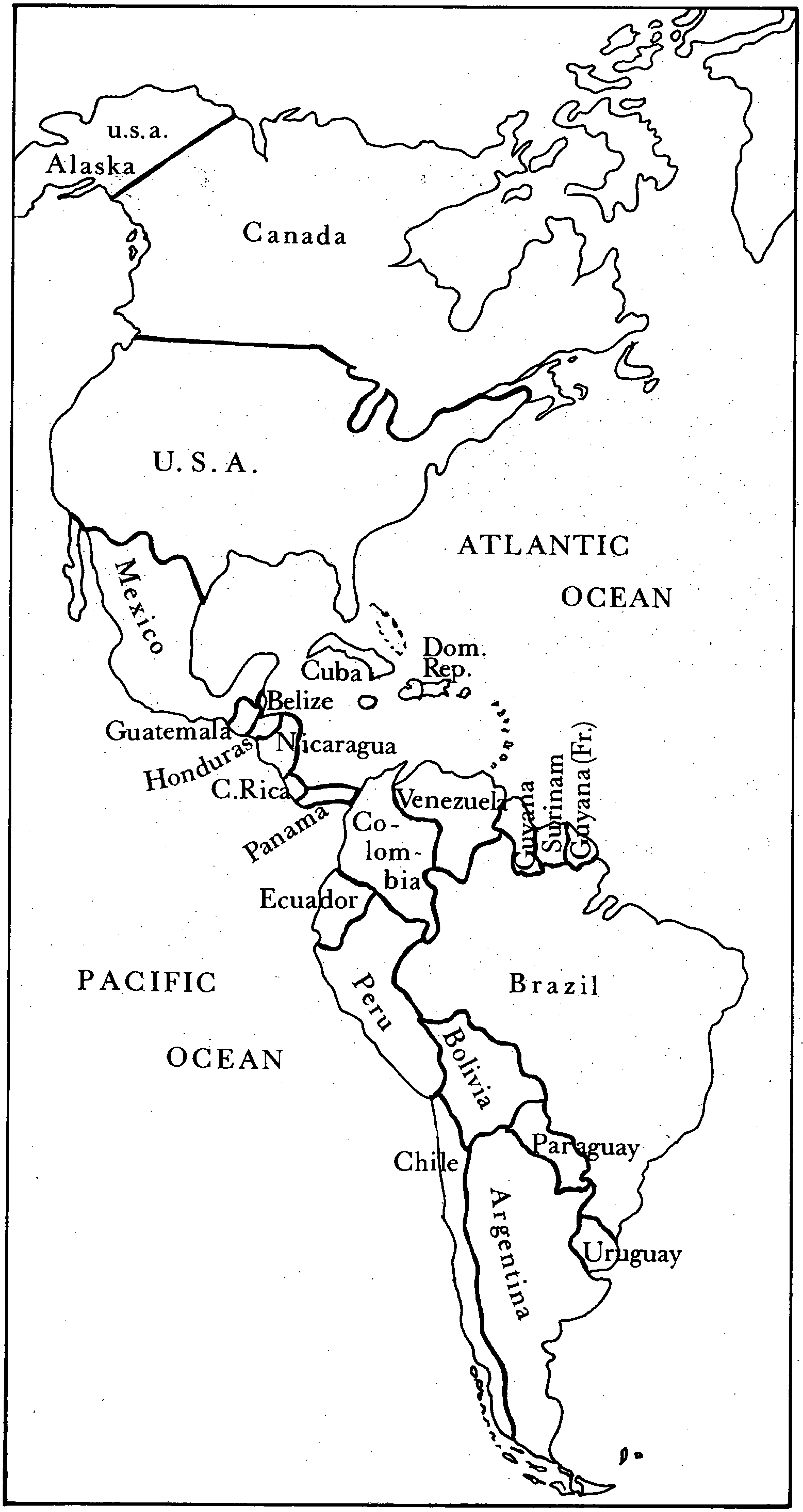
Business International Institute: One Dag Hammarskjold Plaza, New York, N.Y. 10017 (U.S.A.).

Inter-American Centre of Tax Administrators: Apartado 215, Panamá 1 (Panama).

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

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

Seminar Services International: 21-23 Chilworth Street, London W2 3HW (United Kingdom); Passage Perdonnet 1, CH- 1005 Lausanne (Switzerland).




# CIAT

## Conference
## 1977

by Dr. Ramón Valdés Costa

Criteria for the allocatio
of the power of taxatio
among different ta
jurisdictions according t
type of income, assets
and taxable goods
Standards for th
resolution of controversies
inquiries and exchang
of information
Other provisions *

## I. INTRODUCTION

*Inclusion of this topic within the subject matter of this CIAT Conference is, in my opinion, strictly related to the existence of the traditional discrepancies existing between developed and developing countries and, within them, in particular with Latin American countries which, throughout these past four decades, have maintained, with slight variations, the most constant and radical defense of the principle of source, as opposed to the principles of domicile and nationality sustained by developed countries. This characteristic is extensively documented in the literature on the subject, through individual and collective positions taken within the Latin American sphere.* [1] *In the international environment, it was evident as of the first meeting of the United Nations Group of Experts established in 1967, within which the Latin American members adopted an undoubtedly more radical position than the remainder of the members belonging to developed countries.* [2]

*Due to these brief remarks on facts which are perfectly well known by participants at this meeting, it is my intention to discuss the topic with a bearing on treaties between Latin American countries and developed countries.*

*An objective discussion of the topic and formulation of technical and reasonable solutions which may be accepted by both groups of countries is difficult due to the pressure exercised by opposed fiscal and private interests, as well as due to the firmness of the positions of the Treasuries of the respective groups, manifested through domestic legislation, and through the treaties entered into up to now. As was the case on previous occasions,* [3] *the author has the intention of leaving aside such pressures and of attempting to make the most objective and realistic analysis possible.*

*The starting point is the adoption as basic principle of the criteria of source, believing it to be not only the most justified, from an abstract standpoint, in deciding the allocation of the power of taxation, but also because it is the most adequate to obtain the primary aims that, in my opinion, treaties between developed and developing countries must pursue.*

*In this last respect, it seems a timely occasion to emphasize that treaties between these countries should have a more vast and diversified scope than those entered by countries having the same level of development, the basic concern of which is limited to avoid double taxation, a typical example being the treaties entered within the OECD framework. As has already been highlighted by the UN Economic and Social Council in establishing the Special Group of Experts to draft the Model Treaty between developed and developing countries, conventions entered until that time and which "were designed on the basis of the relations between two developed countries...have not been seen with good eyes by developing countries", reaching the conclusion that it was more important to set up "a more adequate system of conventions". To this effect, the resolution deems basic that such conventions contribute "to promote the flow of investment useful to economic development", through tax incentives admitted by both parties. Unfortunately, this has been an aim to which the Group of Experts has not assigned due attention, an attitude which was manifested in the adoption of the OECD Model as a basis for its work*

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* Paper prepared for the Inter-American Center of Tax Administrators (Centro Interamericano de Administradores Tributarios, CIAT), 19th Technical Conference, "The exchange of information under tax treaties" (Curaçao, Netherlands Antilles, August 28 — September 3, 1977), DOC. XIX TC/ 11-6. This paper will be incorporated in a future publication on exchange of information under tax treaties to be published by the International Bureau of Fiscal Documentation.

1. To the excellent bibliography provided in the "Comments prepared by the CIAT Executive Secretariat on the Program for the 19th Technical Conference" taken from the thesis on "International Double Taxation" by Jose Javier Rivera, one may add the report and resolutions of the "Jornadas Latinoamericanas de Derecho Tributario" (Latin American Symposium on Tax Law) which, in our opinion, most precisely and with greater authority reflect the hemispheric viewpoints.
   At the I "Jornadas" held in Montevideo in 1956, important reports were presented which originated the first collective pronouncement in favor of the principle of source as "criterion for the allocation of the exclusive power of taxation" (Edicion de la Facultad de Derecho y Ciencias Sociales de Montevideo, 1957, page 20); at the IV "Jornadas" (Buenos Aires 1964) several resolutions were adopted which represented an evolution with reference to the previous pronouncement, giving greater flexibility to this position (B. Aires, Ed. Cont. Mod., 1966, page 27 and foll.). The above resolutions also have been reproduced in the Publication of the VI "Jornadas" (I.U.D.T. Montevideo, 1971, pages 659 and 665) and under Annex 3 of the Model Tax Code for Latin America (OAS, Washington, 1967). The resolution of the VII "Jornadas", the reports of which are cited in the above mentioned "CIAT Comments", were published by the "Revista Tributaria" (Montevideo, t.II, 1975, page 305). Among the most important individual doctrinary manifestations of earlier times, mention may be made of the numerous articles and reports to Congresses by Eduardo Riofrio Villagomez and Carlos M. Giuliani Fonrouge, as well as of the essay by Hugo Margain, "Tesis para evitar la doble tributacion en el campo internacional en materia de impuesto a la renta, basada en la teoría de la fuente del ingreso gravable" (Thesis to avoid double taxation in the international sphere with reference to income tax, based on the theory of the source of taxable income) Mexico, 1956.
2. In this respect, see the report by Carlos C. Martinez Malteni (Argentine member to the Special Group of Experts) to the VI "Jornadas Latinoamericanas" (op. cit. page 427; reproduced in the "Revista de Impuesto" Buenos Aires, T. XXXIX, page 331 and the different articles by the same author published in the "Revista de Derecho Fiscal", mentioned in the "CIAT Comments".
3. See, in this particular, the general presentation at the VII "Jornadas" (Caracas 1975) published in "Revista Tributaria" T.II, page 185. Under number 3 we maintained that the pronouncements of international meetings aspiring to make advances in the scientific and technical field must take into consideration "the total interests of the Treasuries and of the taxpayers involved...Solutions cannot merely be of fiscal nature at the expense of the legitimate interests of taxpayers...It is also desirable that the pronouncement not identify itself with an irrational defense of Latin American Treasuries."

*which led to the original opposition expressed, as previously recalled, by Latin American members.* [4]

*On the other hand, the non-fiscal goal of these treaties is frequently forgotten in studies made on the subject. Eloquent examples of this characteristic are the Model adopted through Decision No. 40 of the Cartagena Agreement and the LAFTA Draft, although in them this omission finds an explanation in the circumstance that within a rigid concept of the principle of source, as exclusive criterion for the allocation of the power of taxation, provisions in this respect would not be required because the incentive policies would also exclusively be dependent on the legislation of the developing countries.*

*As stated in the report presented under topic I.b of this Conference, all treaties necessarily imply conciliatory solutions and reciprocal concessions. Consequently, no contracting State can expect to obtain a total acceptance of its aspirations and consequently a total waiver by its counterpart. The position of the State as negotiator of the Treaty is essentially different to that of the State as legislator within the domestic sphere. Consequently, a realistic discussion of the topic of Treaties within an International Conference in which countries having different positions participate requires an understanding — and even a transactional attitude — whenever one wishes to make progress in the field of understanding with the intention of entering agreements in the future.*

## II. DOCTRINAL BASES

Within the above orientation, we find the following basic approaches:

1. Adoption of the principle of source as priority, and not exclusive, criterion for the allocation of the power of taxation.
2. Establishment of a system of tax incentives to the investment of the capital and technology required for economic and social development.
3. Maximum cooperation between contracting States to combat tax avoidance and tax evasion, which have increased in these past years and which, although acting to the detriment of both parties, have a stronger impact on developing countries by depriving them of resources which are indispensable to their economies.

These general statements, which are applicable to different parts of this report, require some brief comments.

### 1. Principle of Source

The classical position of Latin America countries, as reflected in the already cited Declaration of Montevideo of 1956, in the Andean Pact Model and in the current LAFTA projects, sustains the application of the principle of source as exclusive criterion. As such, it must be understood that *only* the country of source has jurisdiction over the wealth existing or generated within its territory.

In its pure and strict definition, it also means that this country cannot apply taxes on such assets whenever they are located abroad which, it could be said, represents the counterpart of the above principle.

As the criterion, under which priority is granted to the source country, I understand the recognition of the right of the source country to tax such assets in the first place and at its discretion, notwithstanding the limitations that may be agreed upon in treaties and the ability to levy subsidiary taxes on foreign-source income, allowing credit for tax paid abroad or spared in the source country in conformity with the principle of source. These deviations from the principle may be justified by reason of reciprocal convenience, due to the controversial characteristic of some situations, particularly on the location of the source, and also due to reasons of tax technique and economic polity. On this last aspect, mention may be made of the case of progressive overall income tax, the rational and integral application of which requires computation in some country of total income earned by the taxpayer, no matter in what geographical location the different incomes were generated.

On the other hand, this is the policy which is advisable in order not to stimulate indirectly the fiscally licit ex-

The Inter-American Center of Tax Administrators (CIAT) is an intergovernmental organization established in 1967, reuniting the directors of tax administration of 26 countries in the Americas (Argentina, Barbados, Bolivia, Brazil, Canada, Colombia, Costa Rica, Chile, Equador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Netherlands Antilles, Nicaragua, Panama, Paraguay, Peru, Dominican Republic, Surinam, Trinidad & Tobago, United States, Uruguay and Venezuela).

Center headquarters are located in the city of Panama where its permanent Executive Secretariat operates. The basic objective of the organization is promoting the improvement of tax administration in member countries through the exchange of experiences and the dissemination of information and technical knowledge. In complying with these objectives, the Center periodically convenes conferences on specific aspects of tax administration and holds an annual Assembly with the participation of its members. Since 1968 the Center publishes a monthly Newsletter in English and Spanish, and also edits and distributes the publications concerning its different meetings and Assemblies.

4. ECOSOC Resolution No. 1273 (XLIII of August 4, 1967). At the IV "Jornadas Latinoamericanas" the disagreement between the Resolution and the work of the Group was left on record. In this respect, it was said that the selection of the OECD Draft as the basis for its work "does not contemplate the principles invariably sustained by developing countries; does not coincide with the motivations having evidently originated the establishment of the Committee"; for this reason it reached the conclusion that the manner in which it approached its tasks "does not comply either with the letter or spirit having led to its establishment" (Resolution 2).

portation of national capital toward tax havens or tax shelters, or simply toward countries having lower taxes, a phenomenon which — as is well known — has become quite serious in several Latin American countries.

This priority, and not exclusive, character of the criterion of the source increasingly wins adepts. Authorized background on this subject recognizes that what was known as the SHOUP Mission in Venezuela [5] was adopted by several South American legislatures [6] and is increasingly receiving more support on the part of hemispheric doctrine. [7]

To admit *priority* instead of *exclusivity* does not imply waiving this right, and even less subordination to the country of residence or nationality. Priority, in the correct meaning of the term, means "antecedence or precedence of one thing over another which is dependent on it or derived from it and not to the contrary". For this reason, the priority criterion is not respected in the solutions of the OECD Model when the first country is authorized to tax certain income up to a given rate, and the country of residence or nationality of the taxpayer is left entirely free. On the contrary, it must be understood that the priority criterion recognizes freedom of the country of source to make use of its right to taxation, admitting supplementary taxation by the other party and coordinating both taxations.

### 2. Incentive System

The priority criterion also indicates that coordination is fundamental in the field of exemptions granted as incentive. In principle, the one to decide on the incentive policy is the source country, since it is the one experiencing the need for development and the one making the sacrifice of waiving the corresponding tax revenues. Consequently, this position implicitly carries with it recognition of credit for tax paid as well as for tax saved.

It cannot be doubted that this is one of the most difficult aspects of contemporary international tax law. Even countries accepting the "tax sparing" clause condition its acceptance on the accomplishment of given objectives justifying the waiver of taxation.

The problem and the respective solutions are actually of interest to both countries since they can leave room for abuse, distortions, and useless loss of revenue. Consequently, it seems that the best solution is to grant such incentives only in those cases in which the exemption is necessary, or when it has been proved to be advisable for economic and social development and, when considering the circumstances within the treaty — they have — for practical more than technical or legal reasons — some bearing on the country of residence or nationality of the taxpayer. But what treaties must necessarily avoid is that exemptions granted by the source country not be recognized by the other State, thus making the exemptions granted by the former a mere shifting of tax revenues in favor of the latter.

### 3. Cooperation between Contracting States

Notwithstanding the analyses that we make further on, it is advisable to — very summarily since this is the main topic of the Conference — highlight the importance of this third aspect.

We see no reasons which may justify a restriction to this type of cooperation, since from the standpoint of the nature of things it is inherent to any convention. Agreements are made to be implemented as faithfully as possible and, consequently, no country can deny or restrict its cooperation.

This idea, although generally accepted, has not had the desirable practical implementation. Such a situation merits special attention, if we think of the fact that the increasingly intense participation of transnational companies in contemporary economic and fiscal life requires, for improved control, an also internationalized action on the part of the interested States. The conclusions adopted by the 18th CIAT Technical Conference represent an important basis to determine the field of specific application that cooperation agreements among contracting countries could have.

## III. ANALYSIS OF THE TEXTS

### A. Documents to be Analyzed

The document which, for different reasons, represents the almost obligatory starting point is the OECD Model approved in 1963 and revised in 1977. [8] It is an adjusted continuation of the Model of London of 1946, which has had unquestionable acceptance in treaties entered into by member countries of the organization and also those outside its scope.

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5. Carl S. Shoup (director), John F. Due, Lyle C. Fitch, Sir Donald MacDougall, Oliver S. Oldman and Stanley Surrey, "Informe sobre el Sistema Fiscal de Venezuela", Caracas, Ministry of Finance, 2 t. 1960 (in particular, see t 1. page 247 in which the following reasons are given: "to increase fiscal revenues", "promote domestic investment" and "afford a more equitable treatment to its residents in taxing their overall income without taking into account the place where it was generated").
6. Among them, in Uruguay in 1960, based on our initiative and with the support of Mr. Edison Gnazzo, then advisor to the Ministry of Finance.
7. The IV "Jornadas Latinoamericanas" included a significant favorable pronouncement in this respect which, although not having obtained the necessary majority (13 votes against 11), reunited the votes of qualified specialists of Argentina, Uruguay and Venezuela. It has also been recently defended by Enrique Piedrabuena Richard in his reports to the VI "Jornadas" and to the Seminar organized within the IFA Congress (Mexico 1974) published in the *Bulletin for International Fiscal Documentation,* Vol. 29, No. 2 (1975) page 51, and, also in *Fiscal Harmonization in the Andean Countries,* page 35.
8. "Draft Double Taxation Convention on Income and Capital", OECD C (63) 87, of which there are official versions in French and Spanish; "Revised text of certain articles of the 1963 OECD Draft Double Taxation Convention on Income and Capital and of the Commentaries Thereon" (OECD General Distribution, April 1972; of which there is a French text). Review by the Committee of Fiscal Affairs of Arts. 1, 2, 3, 6, 8, 9, 11, 12, 22 and 25. The complete text of the 1963 Model with the revisions and their respective com-

The Special Committee of Experts of the United Nations has published its first six reports as well as the "Guidelines for tax agreements between developed and developing countries", a publication in which the amendments to the OECD Draft are given and which summarizes the discussions held within the Group of Experts and formulates conclusions in the manner of Guidelines which, according to the publication itself, represent "a manual destined to the governments of member states" and, in particular, "to the negotiators of tax agreements between developed and developing countries in order to assist in the negotiations and facilitate the entering of tax agreements". [9]

Within the Latin American sphere we, in the first place, find the official documents of the Cartagena Agreement and the Technical Reports of LAFTA which systematize, in the manner of a draft treaty, the conclusions that the Experts on Double Taxation have formulated to date, which, in turn, have been agreed upon at the Meetings of Directors of Internal Taxation. [10]

Among the pronouncements made by private scientific institutions, we should highlight those of the Latin American Symposium "Jornadas Latinoamericanas" [11] and those of IFA which, in its annual Congresses, has assigned preferential attention to these problems. [12]

It can be stated that these documents represent a faithful reflection of the current stages of the problem and of the opinions predominating in the international and, in particular, the Latin American sphere.

### B. Income from Real Estate

This is the problem on which there is least discrepancy. Both the OECD in its Article VI and the Andean Pact Models (as of now called AP) and that of LAFTA (Article V) coincide in recognizing the power of taxation of the state in which the real estate is located.

A difference could only be found between OECD and LAFTA in the concept of real estate. In the former, the expression includes accessories, cattle and equipment used in agricultural and forestry concerns, and expressly excludes vessels and aircraft.

In the LAFTA comments it is said that this solution has been left aside because it does not adapt itself to the criterion predominating among the experts, who define the location of the source generating the income in a separate manner for cases of lease or transfer of the right to exploit or use natural resources. As a substitution, LAFTA attempts a definition of real estate income which is more commonly admitted as such and which should be addressed to the stipulations of the respective national legislations.

### C. Income from Industry and Commerce

Apparently there is also agreement in recognizing the right of taxation where these are concerned. However, the OECD and the Special Group of Experts of the United Nations (from now on called the UN Group) firmly sustain the thesis of regularity and permanence of the activities generating the income, through the existence of a permanent establishment, as a requirement to justify the competence of the country of the source. Latin American countries — also firmly — resist this conditioning, as was seen during the meetings of the UN Group at which it was not possible to reach a satisfactory agreement on this point. Finally, the concept of permanent establishment was maintained as "fixed place of business in which an enterprise develops all or part of its activities". The reasons given for maintaining this concept do not seem to be very convincing; difficulties in determining the net income generated by accidental type activities were alleged as well as the fact that the limitation derived from the permanent establishment would promote international trade in permitting the enterprise located in one contracting country to expand their operations to the other country, without risking local taxation whenever not developing important and continuous commercial activities.

We find more convincing the objections of developed countries concerning the loss of revenue and in particular the great progress in communications and in commercial methods which permit enterprises to obtain income from sources located in developed countries with increasing ease without the need for their formal consideration as permanent establishment. [13]

These discrepancies leave room for small concessions concerning given situations considered as permanent

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mentaries may be found in *Supplementary Service to European Taxation* January, February 1976. It also contains specialized bibliography.

9. "Tax Treaties between Developed and Developing Countries" Ed. 69 XVI 2; E1 E71, XVI-2; E72 XVI 4; E 73 XVI-1 E 75 XVI.I; E76 XVI.3 "Guidelines" (op. cit. S 74 XV15).
10. See our report on topic I.b of this Conference (to be published in the next issue of the Bulletin).
11. See Meetings of Montevideo (1956), Buenos Aires (1964) Punta del Este (1970) and Caracas (1975).
12. At the Congress of Mexico (1974) a Seminar on the Andean Pact Model took place, with the participation of speakers representing different positions; the Seminar was directed by Prof. Stanley Surrey and the speakers were: A. Atchabaian R. Valdés Costa, E. Piedrabuena Richard, François Gendre J.S. Hausman and P. Sibille. It was published by the International Bureau of Fiscal Documentation under the title *Fiscal Harmonization in the Andean Countries* (1975).
    At the Montevideo Congress a Round Table was held on the "Tax Sparing" clause as a factor to promote foreign investment in Latin America, with Prof. Leif Muten acting as general rapporteur and with the following official rapporteurs Prof. D. Throop Smith, J. van Hoorn Jr., Enrique Piedrabuena, H. Garcia Belsunce and D. Vaz ("Debates en Mesa Redonda" — XXII IFA Congress, Mont. 1970).
    Among these latter pronouncements it is worth recalling that of the London Congress of 1975, the agreement of which with the resolutions of the VII "Jornadas Latinoamericanas" of Caracas held in that same year is remarkably significant.
13. Among the most recent and authorized criticisms of the requirement of a permanent establishment to justify the power of taxation of the source country, mention may be made of A. Atchabaian in his paper "The Andean Subregion and its approach to avoidance or alleviation of international double taxation" in which he calls this requirement "an obsolete and technically not conceivable aspiration" (*Fiscal Harmonization in the Andean Countries*, op. cit. page 25).

establishments. For example, the reduction of the term from 12 to 6 months in the case of works, constructions, or assembly projects and, as a second possibility, that of considering that the existence of a permanent establishment would be deemed as being represented by charges payable for the project or activity in excess of 10 percent of the sale price of the machinery or equipment (Item g, paragraph 2, Article 5 of the OECD draft).

A similar solution was promoted with reference to the rendering of other services by an enterprise (Item h of the same paragraph).

One of the small concessions made to the concept of permanent establishment is found in the concept of agent provided for under paragraph 5 of Article 5, establishing that whenever the agent conducts all or almost all, of its activities on behalf of such an enterprise, it would not be considered as an independent agent within the concept of this paragraph and, consequently, would represent a taxable situation for the enterprise.

On the other hand, the AP and LAFTA solutions integrally sustain the concept of source exclusively relating it to the place where the entrepreneurial activities are developed. However, we should note that LAFTA makes an exception concerning the exclusion of the profits derived by enterprises engaging in the rendering of personal services, which are governed by the special provisions of Article 21.

As noted in our report on topic I.b, these two models contain original solutions with reference to situations which could be considered as permanent establishments. In them, this mention only has the character of representing an absolute assumption of location of the income in these places, but without excluding the possibility for the taxation of other income which is not included within these considerations.

The problem of a same enterprise conducting activities in another state is in principle solved by giving each State the competence to levy the tax on sales. But the same discrepancy again arises with reference to the existence of a permanent establishment, where we find the added possibility of application of the norm called "force of attraction" which represents an expansion of the "allocation" norm promoted by the OECD Model. Within the UN Group this aspect was discussed and it established an amendment expanding the concept by considering the sales or activities similar to those developed by the permanent establishment as taxable (Article 7, paragraph 1 of OECD).

An important problem is that concerning the application of the principle of "independence" in order to determine the profits which may be allocated to the enterprise and to its permanent establishment. OECD and UN provide that to the establishment shall be attributed the "profits that it would make if it were a different and separate enterprise developing the same or similar activities, under the same and similar conditions and treated with total independence of the enterprise of which it is a permanent establishment" (Article 7, No. 2, of OECD).

It must be pointed out that within the UN Group an important amendment was introduced to paragraph 3 of Article 7 of the OECD Model with reference to the possibility of deducting payments made by the permanent establishment to the company headquarters. Following the initiative of developing countries, and concretely expressed by India, it was in principle accepted that the profits of the permanent establishment would be calculated taking all expenses incurred into account; however, paragraph 2 states, "the payments made by the permanent establishment would not be deductible (whenever not made as reimbursement for actual expenses) to the headquarters of the company, or to any of its other branches, in the manner of royalties, fees or analogous payments" (see Second Report, No. 79 to 82 and First Report, Annex 5).

A similar solution is established under Article 7 of AP and Article 16 of LAFTA, paragraph 1; but these two, through different means, introduce important exceptions. To the first would be applicable Article 21 of Decision No. 24 of the Cartagena Agreement, according to which payment of royalties would not be authorized, nor would any deduction for this concept be admitted for tax purposes. The LAFTA draft, in a second optional paragraph, recognizes the right of the State where the permanent establishment is located "to deny expenses corresponding to the use of capital or technology belonging to the enterprise or to the rendering of services on the parts of components of a same company in the other contracting State...".

Our opinion on this problem is well known, even within the CIAT framework.[14] We have maintained that tax treatment in these cases should follow "the general standards applicable to independent companies notwithstanding the fact that the following is recommended: a) the establishment of special systems for unilateral and joint controls on the part of the interested States, to avoid the distortions verified through experience, and b) the adoption of legal limitations and requirements preventing the abuse which cannot be checked through administrative controls".[15] This principle, which was presented to the VII Latin American Symposium "Jornadas Latinoamericanas" held in Caracas in 1975, was expressly adopted in the same terms. At the XXIX Congress of IFA which was held in London immediately afterwards, this criterion was also admitted with express reference to technology establishing that taxation of these payments "must follow the general rules applicable to independent companies inasmuch as their payments are in agreement with the prices of the free competition" (arm's length). At the recent 18th CIAT Technical Conference the same criterion was implicitly admitted. In establishing the manner to combat tax avoidance and evasion on the part of transnationals through adjustment of their

14. "Abuses in expenses incurred abroad", report presented to the CIAT Assembly (Rio 1971) and reproduced with additions in the "Revista de Derecho Fiscal", t.xx XXI, page 1.

15. "Tax treaties between developed and developing countries", report presented to the VII "Jornadas Latinoamericanas"; Rev. Tributaria T.II page 185, published in "Revista de Derecho Fiscal", T. XXV, page 577.

transfer prices and transfer of the reality of same, it is indirectly being admitted that these operations are adequate and, consequently, expenses may be deducted by the permanent establishment or affiliate.

In this respect, the evolution of certain legislation, such as that in Argentina, is also illustrative. The Act, having ratified and strengthened the jurisprudence denying the possibility of the existence of contractual relations between related companies, has recently been modified establishing that such legal actions will be considered "to all effects as held between independent parties whenever the services and conditions are adjusted to the normal practices existing in the market between independent entities", also establishing some limitations which do not alter the efficacy of the principle. [16]

## D. Related Companies

Article 9 of OECD, concerning the possibility of adjusting the profits of a corporation in order to make them agree with the profits they would have made if the relationship did not exist and which, in fact, have not been generated on account of same, has been widely accepted. It was not objected to by the UN Group and has been tacitly included in the AP Model while it has been expressly included in the LAFTA Draft (Article 17); although with regard to the latter it must be noted that also in this case — as was the case with Article 16 — it recognizes the possibility for the interested State to deny the independence of such companies for purposes of the establishment of the treatment afforded to certain payments.

As is stated in OECD Comments to Article 9, "it is perfectly normal to provide for the possibility to make an adjustment in such cases and the Article seems not to require any further comments". It is of interest to point out that the revised OECD text adds a 2nd paragraph to this Article admitting that in the case of adjustment of the balance-sheets of one of the companies, an adjustment must also be made in the other in order to avoid double taxation whenever the profits allocated to the former through the adjustment have also accrued taxes for the latter. The solution is justified from the technical standpoint but it poses a problem of a formal nature that the text does not solve, giving the contracting States total freedom "to establish through mutual agreement the precise rules to be provided for under this Article".

## E. Dividends

As is widely known, in Latin America there is no doubting — at least at official levels — the fact that dividends must be exclusively taxed in the country of domicile of the distributing company. Solutions fully coincide under the AP Model, partially under the LAFTA Draft; and the Resolutions of the 1st Latin American Symposium, particularly under those of its 7th Session. The solution is derived from the Model Convention of Mexico of 1943 where it was established that "income derived from real estate can only be taxed by the contracting State where the capital is invested".

OECD, instead, establishes the priority right of the State of residence of the shareholder (Article 10(1)). "However" — paragraph 2 of this Article adds — "these dividends may be taxed in the Contracting State where the company resides...but the tax thus levied cannot exceed certain limits (5 percent and 15 percent according to the case) to be established through mutual agreement by the competent authorities of the Contracting States".

This problem is undoubtedly related to the organization of the progressive overall income tax. There are no doubts as to taxation of the shareholder residing in the same country in which the company pays the dividend; in such a case the difficulties which may arise are purely of administrative techniques. The problems and the diversity of legislative solutions arise with the dividends paid by local companies to non-resident shareholders, and with the dividends received by resident shareholders from foreign companies. The lengthy comments of OECD on this subject, the different solutions given by comparative legislation as set forth in the Report by the Secretary General of the UN Group of Experts, and the numerous reservations expressed by the adhering countries represent the best proof of the difficulty of the problem.

The Latin American solution may be called simplistic. Although it seems unquestionable that the State of residence of the company has the indisputed right to tax that dividend — since it is income generated in its territory — the right of the State of residence of the shareholder to compute that dividend within overall income and, consequently, to tax it seem also to be unquestionable. The same solution would obviously apply in the opposite situation.

The solutions would thus seem to lie in recognizing the right of the State of residence of the company to tax all dividends it pays, in the manner it considers most advisable, but without establishing discriminations

**COURSE ON DOUBLE TAXATION IN MEXICO**

An intensive course on "Negotiation of Tax Treaties" will take place in *Ajijic, Guadalajara* (Mexico), February 20 through March 17, 1978. The course will be offered in Spanish. It is being organized by the Institute for the Technical Development of Public Finance, an intergovernmental organization of Mexico, and will have the cooperation of the German Foundation for International Development which, besides providing important financial support, will contribute a group of experts — including Latin American experts — to offer lectures on different parts of the Course.

This Course, offered in Spanish, is aimed at making an overall analysis of the problems involved in negotiation of tax treaties. The participants will be officials from all CIAT member countries. CIAT also plans to hold a similar course in English. Mr. *Jorge Alberto García Cáceres*, Assistant Director for Legislative Matters at the Coordination of Fiscal Studies and Resources of the Under-Secretariat of Revenue of Mexico, was appointed General Coordinator of the Course.

16. Act 21.481 of December 30, 1976, art. 6, to amend art. 14 of Act 20.628.

ıgainst non-residents — and of recognizing, for the State of residence of the shareholder, the right to establish supplementary taxation, particularly concerning progressive overall income tax, granting the corresponding tax credits for the tax paid or saved in the country of source.

t should be added that this is the solution recommended y the "Jornadas de Caracas" where adhesion to the rinciple of source was ratified as *"fundamental and f priority...notwithstanding the subsidiary application f the other principles..."* (Resolution 2). In dealing vith the problem of location of the source, this Resoıtion simply states that the source of income (attendng to the "common characteristic of the relationship etween the taxpayer and the place where the income s earned") "is the place where the distributing comany functions". It does not establish — as do the AP nd LAFTA Models — the exclusive right to taxation of his income by the country of domicile or residence of he company.

## F. Interest

'his is one of the most controversial aspects. The counries up-holding the criterion of source firmly sustain heir right to tax this income, although in a notoriously mprecise manner in regard to what is to be understood s source. As early as the Convention of Mexico of 943, for the location of the source, indiscriminate se has been made of such terms as location of the investment"; "placement"; or "use" of the borrowed apital, and even of the "place where the resources have een generated for payment of this type of income". [17] 'o further complicate the issue, there has arisen, withn LAFTA, a theory of the "paying source". [18] This ncertainty is also variable in developed countries. n the Report by the Secretary General, H.G. Gumel, [19] to the United Nations Group of Experts one nay read that "in international law it is recognized that he place where the liability is located is that of the resilence of the debtor; a certain number of capital-exportng countries apply this norm in their domestic tax legisation and, through withholdings at the source — at ften high rates — tax the interest received by resilents or non-residents. However, in their Conventions vith other countries they continuously apply the opposite principle; that of exclusive taxation by the counry of residence of the creditor". This leads the author o maintain that the arguments according to which the ource of income involved is to be considered as beonging to the country of origin of the capital or, conersely, to the country where the capital is utilized ave the same strength from the logical standpoint. He oncludes by stating that legal arguments are not deisive.

)n the other hand, the OECD Commentary to Article 1 establishes that "all the OECD Member countries tax nterest arising abroad to their residents, two-thirds of hem tax interest arising in their territories to non-resilents and one-third do not tax interest at the source at ll". It adds that discussions that took place evidenced hat a formula reserving the right to tax interest exclusively to the State of domicile or of the source could not ensure general agreement.

Consequently, the only possible solution for the Fiscal Committee has been that of leaning toward adopting a compromise solution. In this sense, it established the *priority* right of the State of residence of the creditor of the interest, simultaneously recognizing the possibility that the paying State might require payment of limited tax.

In our opinion, having accepted the principle of source, the solution is clearly in favor of the country where *the lender's income* is generated; in other words, the country where *he invests or places his capital* which, as a rule, will coincide with the place from which the payment is made or in which the debtor is domiciled, but which may very well not coincide. As stated in Caracas, the decisive element which, on the other hand, is common to all problems of location of sources lies *in the relation between the taxpayer and the place where he earns the income.* The circumstances that the borrowed capital be afterwards transferred or re-invested by the lender in another country cannot alter the legal-tax relation between the lender and the Treasury of the country where he placed his capital. There is no valid legal reason for the tax obligations of the lender to be altered by new legal facts or actions which are totally foreign to them. Later operations made without their participation may originate new legal-tax relationships, by virtue of which the countries in which the capital is in fact utilized, or in which the profits through which income is paid are generated, have the right to collect the taxes established by their domestic legislations; however, we repeat that these consequences of later transactions cannot affect the obligations resulting from the initial loan.

For this reason, the criterion of placement in the strict sense of the word, and not as synonym of utilization or employment, seems to us to be the most adequate criterion. The place of payment and that of domicile or residence of the debtor should only be used as simple assumptions of the site of placement.

Such is the mechanism taken by Mexico and AP Models: the first establishing the assumption of domicile; the second, that of the place from which the payments are made.

## G. Interest on Deferred Payments

The much debated problem of interest on sales with deferred payment has not, to date, been given a satisfactory solution. Many factors present obstacles to an agreement, among which we may cite the complexity of these transactions, the diversity of the financial characteristics, terms, the participation of government agencies, the economic interests involved, both in regard to exporting countries and to developing countries. Consequently, it is not surprising to find that there is a

17. Jose Wurgaft Barr, Report presented to the VII CIAT General Assembly held in Guatemala in 1973, page 301.
18. See our report on topic I.b.
19. H.G. Gumpel "Questions relatives aux conventions fiscales entre pays developpés et pays en voie de developpement". U.N. New York F 69, XVI, 2 page 49.

trend to avoid taking a position on the subject. An example is the case of AP in which, although the problems were outlined in preliminary studies, no provision was included to this effect. Instead, the LAFTA Draft took a stand for taxation in the same manner as interest; in other words, exclusively by the importing country. The most significant illustration of these difficulties is that of the studies made by the UN Group. The point was extensively debated and — as in the case of interest in general — what are called "Guidelines" do not in this case have such a character. With reference to interest in general, the substantial part of the position taken states that both one and the other country may levy taxes on interest and that "in bilateral negotiations these rights to tax collection will normally be taken into account, and they will be taken into consideration in the measure in which this is agreed upon". With reference to interest on "deferred payments" it states that: "although the aspect of interest on deferred payments or on sales on credit should be considered within the context of the article of the agreement concerning interest in general, the manner in which it will be considered and the final decision should be left to the process of negotiation". In Latin American doctrine, as well as legislation and jurisprudence — although with discrepancies — the respective countries in the area are in favor of taxation by the different countries. However, mention must be made of an unquestionable concern to avoid the effects of double taxation and of its consequence that the tax — theoretically payable by the foreign seller — be translated by Latin American importers, and in particular by industrialists, into an increase in the cost of purchase of capital goods. In this respect, we frequently find exemptions in legislation on the matter.

Personally I believe that this is an issue where the non-fiscal aims which are to be sought by agreements between developed and developing countries become evidently manifest, which would justify an agreement not so much to assign the power of taxation to one or other country, but to establish tax reductions or exemptions to stimulate capital investment in developing countries. 20

As will be recalled, this was one of the most important specific purposes of ECOSOC in its establishment of the Special Group of Experts. The anodyne guidelines of same, which were transcribed above, highlight the measure in which the expectations originated with its establishment have been frustrated.

## H. Royalties

The situation is similar to that of interest although discrepancies are more acute. OECD, which admitted doubts on the former, in this case adopts a radical position in sustaining the *exclusive* right of the country of residence of the licensor collecting the tax. On the other hand and as is obvious, the AP and LAFTA Models sustain the exclusive right of the paying country, with the addition of denial of the right of transnationals to compute these transfers for tax purposes, particularly with regard to their deduction as expenses incurred by permanent establishments and affiliates or branches. The Group of experts also avoids taking a concrete position in this respect, recognizing the right to taxation o[f] both types of countries, and leaving conciliatory solu[-]tions to bilateral negotiation "to the extent agree[d] upon".

On a previous occasion while trying to refute the positio[n] of the International Chamber of Commerce which recognizing the right to taxation of the country o[f] source, considers that the latter is represented by "th[e] place of residence of the owner", in other words, "th[e] place in which he decides his investments", I said tha[t] in our opinion capital was being confused with income[.] The trademark or patent is capital undoubtedly forme[d] in a given country as a consequence of experience, re[-]search or inventions having taken place in same. But th[e] income this capital may generate does not derive fro[m] its mere existence but from its economic, industrial o[r] commercial use; in other words, from its utilizatio[n] either in the same country or in another. Consequently in order to determine the origin or location of the in[-]come subject to the tax on royalties, attention is not t[o] be assigned to the country in which the capital wa[s] formed, or in which its owner now resides, but to th[e] country where the capital is used to generate the in[-]come. What is taxed is the royalty in its character o[f] remuneration for the trademark or patent and not th[e] latter in themselves. 21

### 20th CIAT TECHNICAL CONFERENCE IN BUENOS AIRES

The 20th Technical Conference will take place in Buenos Aires from March 26 through April 1, 1978, on the topic: "Principal Aspects of Tax Collection". This meeting, to be developed on the basis of Work Group discussion, is aimed at determining the basic problems of tax collection within a current and practical framework, as well as solutions applicable to each situation. With the passing of Resolution No. 4008 of August last year, the Secretariat of State for Finance of the Republic of Argentina appointed the Executive Committee for the Conference, formed by the following officials of the General Directorate of Taxes (DGI): *Jorge Eduardo Sandullo*, Chief of the Collection Department is General Coordinator, with the following members: *Victor Fernandez Balboa*, Chief of the Administration Department; *Juan Carlos Jimenez*, Chief of the Collection Zone of Buenos Aires; *Marcelo Ramon Lascano*, Chief of the Studies Department; and *Pedro Raul Kondratiuk*, Advisor to the General Directorate. Additionally, an organizing Committee was set up with the following DGI officials: *Beatriz Calvo de Bagur*, Advisor to the Administration Department; *Jose Luis Garcia Rios*, Advisor to the Collection Zone of Buenos Aires; *Guillermo Omar Cortese*, Advisor to the Collection Department, and *Ezequiel Beron de Astrada*, Advisor to the Studies Department.

20. A development of these concepts may be found in my re[-]port "Interest paid abroad for purchases with deferred pay[-]ment. Latin American Tax System", prepared upon request by IFA for the UN Group of Experts. published in "Revista de Derecho Fiscal", T.XXIII, page 546.
21. Report to the VII "Jornadas Latinoamericanas" of Caracas op. cit. page 190.

But apart from this problem of allocation of the power of taxation, and surely more important than it in regard to treaties between developed and developing countries, is the possibility of coordinating the positions of both States to stimulate, through taxation, the transfers of technology required by, or useful to, development. The arguments are the same as those given for the case of transfers of capital and sales on credit, although specific characteristics appear in this case.

Difficulties in control, particularly in the field of related companies, are so many that Treasuries have raised understandable objections to the liberalization of tax policy on the subject. Further, this problem of incentives is closely related to the characteristics of the transferred technology, particularly to its usefulness and possibilities for substitution for domestic technology. The problem transcends the strictly defined tax field, but it must offer guidelines for collaboration in this transfer of technology whenever there is a political decision concerning its usefulness or need for the process of economic and social development. In this respect, it is of interest to highlight the statements of the VII Latin American Symposium "Jornadas Latinoamericanas" and of the XXIX IFA Congress which have already been mentioned in this report. In the former, in recommending the entering of treaties inspired by the principle of source for non-tax purposes, the objective first proposed is the following:

> "to facilitate the above mentioned transfers to developing countries by means of the granting of incentives equitably distributed between the contracting states, limited to the needs of development and conditioned to an effective decrease in prices..."

The main thrust of the IFA Congress was that: "In the modern world free transfers of technology are desirable" and in this respect it was stated "that the tax system on payment for transfers of technology by capital-importing and capital-exporting countries must not only not hamper these transfers but must, on the contrary, promote it and, in particular, avoid double taxation". Among the recommendations included are those of taking a tax exemption on payments into consideration; the applicability of their deduction by the company in all cases, including the case of related companies; and recognition on the part of the exporting country of the exemptions granted by the importing country, granting tax credit for the exempted tax either through treaties or by means of the adoption of unilateral measures.

## I. Technical Assistance

This topic is usually discussed together with that of royalties. However, Latin American doctrine and the AP and LAFTA Models in our opinion adequately differentiate it since, from the standpoint of the concept of the source, when correctly understood, the solutions do not coincide.

Contrary to what happens *stricto sensu* in the field of royalties, payments for the technical assistance typically rendered (in other words, not the technical information habitually leading to the transfer of use of a patent) should be taxable in the place where the services are rendered, or, better said still, in the place where the activity that will be subject to remuneration is developed. This was the classical concept of Latin American doctrine and of most of its legislation. Such is also the solution propounded by the AP Model. Within LAFTA, as was stated in the report on topic I.b, the situation is diffuse and sets forth three alternatives related to the place where the services are *rendered*, to that in which they are *used*, or from which they are paid.

The UN Group, following the orientation of OECD, although recognizing the right to taxation by the country where the services are rendered, adds as a requirement the existence of a "fixed base" regularly available to the one who renders the services, or of a stay of more than 183 days within a given fiscal year in the other contracting State.

## J. Resolution of Controversies

The necessary complement to all legal provisions is the regulation of adequate procedures for their effective implementation and for the resolution of controversies that may eventually arise.

The OECD Model in its Articles 25 and 26 provides for both of these aspects. Article 25 provides for what is called "friendly procedure" as a means to consider, on the basis of mutual agreement by the States, a solution to the claims of residents of one of the contracting States whenever invoking a violation of the Treaty. These resources, apart from those which may be applicable according to the legislations of the States, must be filed with the country of residence of the taxpayer, the competent authority of which must — as the Commentary states — "make a careful review of the request and require presentation of available evidence". Whenever it is "not in a situation to arrive at a satisfactory solution, it will do what is possible to resolve the issue through a friendly agreement with the competent authority of the other State". The third paragraph states that these authorities should do everything possible to resolve difficulties through friendly agreements or to clear up doubts by directly communicating between them, and even establishing the possibility of setting up committees formed by representatives of both States.

The revised text established minimum terms for the filing of these claims and, as an addition to paragraph two, that the agreement will be applied "whatever the terms established by the domestic legislations of the contracting states may be". This solution led to numerous reservations based on the need to respect the provisions of domestic legislations.

These conciliatory solutions should be undertaken as a first step. What would be desirable would be to undertake an effective and correct implementation of the treaty in all cases; in other words, even whenever an agreement is not reached by the contracting parties. The establishment of an international jurisdiction doubtless finds the obstacle of resistance originating in the traditional concept of national sovereignity; but increasing regional integration is opening favorable perspectives in this respect. As a background element to be taken into consideration, we may recall the favorable statement made by the XXIII IFA Congress held in Rotterdam in 1969 which in the case of inadequacy of friendly procedures, as regulated by OECD Article 25, foresees the possibility of establishing courts for international arbitration which would be expressly accepted by the States involved.

### K. Exchange of Information

This mechanism does not, in principle, give rise to any resistance, but it would seem to be hampered by reticence originating in the secrecy of certain information. Article 26 of OECD provides that the competent authorities "will exchange the information required for the application of this convention and by the domestic laws of contracting states governing the taxes included in same". It also provides that information will be maintained secret and may not be disclosed to any person or authority not responsible for the assessment or collection of the pertinent taxes. In its second paragraph it establishes prohibitions concerning compliance with the legislation or administrative practice of the States; those concerning an industrial or professional secret and information the communication of which is contrary to public policy.

This Article was extensively discussed by the UN Group and the Guidelines recommend its expansion foreseeing that inquiries may also concern "tax avoidance" or "tax dodging". It also recognizes the secret character of the exchanged information, but adds that it "may be disclosed to any persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of the taxes which are the subject of the Convention".

The AP and LAFTA Models follow these general lines and, as a specific characteristic, mention may be made of the inclusion within the LAFTA draft of an express reference to the possible auditing of the transactions made internally by parts of a same company or by companies part of the same corporate group. This provision is related, as the Commentary states, with the need to verify and, when applicable, adjust the prices and values taken by the parties. All of these manifestations reveal the concern of the States with regard to the administrative problems originated in the activities of transnationals.

# ASIA Regional Cooperation in Taxation and Customs*

## 1. Study Group on Asian Tax Administration and Research (SGATAR)

Regional cooperation in taxation began in 1970 in Asia with the establishment of the Study Group on Asian Tax Administration and Research (SGATAR) by the member countries of the Ministerial Conference for the Economic Development of South East Asia.

The Ministerial Conference for the Economic Development of South East Asia was first convened in Tokyo in 1966 on the initiative of the Japanese Government. Its purpose was to provide an annual opportunity for cabinet ministers of South East Asian nations and Japan to exchange views on common problems involving economic development and on ways to accelerate growth in South East Asia through multilateral arrangements.

The idea of Asian countries working together in the field of taxation was a Philippine proposal presented by Secretary of Finance Cesar Virata during the 5th Ministerial Conference held in Jakarta and Yogyakarta on May 22—25, 1970.

Following its adoption, the 5th Ministerial Conference issued a joint communique which stated the need to organize a Study Group for the review and exchange of information about tax structure and administration, especially concerning the development requirements of the countries of South East Asia. The Philippines was invited to host the first meeting of the Study Group. Pursuant to the joint communique, the Philippine Government extended invitations to member countries of the Ministerial Conference for the Economic Development of South East Asia to send directors and senior tax officials to attend the first meeting of SGATAR in February 1971.

The countries which have consistently attended the SGATAR meetings are Japan, Indonesia, Malaysia, Singapore, Thailand and the Philippines.

Burma, Vietnam (Republic of), Cambodia and Laos have participated in two or three of the meetings. Australia and New Zealand participated for the first time during the fourth meeting held in Kuala Lumpur.

SGATAR has so far met on an annual basis in the various capitals of its members; the main topics discussed are outlined below.

*I. Manila, February 14—21, 1971*
1. Fiscal Incentives to Promote Domestic and Foreign Investments
2. Some Aspects and Problems of Tax Administration Relating to the Operation of Fiscal Incentives
3. Exchange of Information

*II. Jakarta, February 21—25, 1972*
1. The Role of Sales Taxation in Developing Countries
2. Some Aspects of Income Tax Evasion and Avoidance
3. Some Aspects of Tax Treaties Between Developing and Developed Countries

*III. Tokyo, May 28—June 1, 1973*
1. Taxation of National Resource-Based Industries
2. The Relationship Between Taxpayers and Tax Authorities

*IV. Kuala Lumpur, July 21—27, 1974*
1. Taxation Structure and Problems of Corporation and Shareholders, Royalties, Interest and Rent
2. The Income Tax Collection Machinery and Techniques Employed in Recovery of Arrears
3. Administration and Enforcement Problems of Sales Tax

*V. Bangkok, May 12—18, 1975*
1. Estate and Inheritance Taxes
2. Fiscal Measures to Encourage Exports
3. Development of Tax Personnel
4. The Organizational Structure of an Income Tax Office
5. A Common Nomenclature for Tax Terms

*VI. Singapore, October 25—30, 1976*
1. Financial Leasing
2. Scheme for Effective Income Tax Administration and Experience in Increasing Compliance of Taxpayers
3. Property Tax

*VII. Canberra, November 21—25, 1977*
1. Aspects of Investigation and Audit of Taxpayers' Taxation Affairs
2. The Role of Internal Auditors in Government in General and in A Taxation Office in Particular
3. Roles in Taxation Offices for Computers, Microfilming and Other Modern Office Facilities
4. Review of the Revised Glossary of Tax Terms

Papers prepared by member countries on the main topics are published by the host country in the Final Report of Proceedings of the Study Group on Asian Tax Administration and Research, for distribution to the member countries which participated in the conference. Those documents are therefore only available to the countries which took part in the conference and are, in

* This report was prepared by Mr. K.S. Jap, senior associate of the International Bureau of Fiscal Documentation.

principle, not subject to wide dissemination. However, the library of the International Bureau of Fiscal Documentation possesses some of the annual Final Reports of SGATAR.

## 2. ESCAP Seminar on Foreign Investment and Tax Administration

Under the title "Foreign Investment and Tax Administration", the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) has held two seminars at two-year intervals in respectively Manila (1974) and Tokyo (1976). [1]

Both seminars were attended by high-level administrative personnel from the member countries of the region. The seminars were funded by the Government of the Netherlands and organized by ESCAP. Both seminars were chaired by the managing director of the International Bureau of Fiscal Documentation in Amsterdam which is preparing for ESCAP a loose-leaf publication entitled "Taxes and Investment in Asia and the Pacific", [2] presenting a compilation of the tax systems and investment laws of ESCAP regional member countries according to a common outline.

One of the objectives of the seminars is to increase understanding of the tax systems of various countries of the region and to set in motion a process of development which will result in the evolution of a system of taxation which has a common basis among all regional member countries.
The opportunity to meet and exchange views and experience on a regional and international basis will promote better understanding of tax legislation and its application in the countries of the region. Such developments would provide an effective means of facilitating intraregional cooperation as well as international cooperation in the region, in the fields of taxation and investment law.

In dealing with the agenda on investment, the Second Seminar on Foreign Investment and Tax Administration agreed that specific attention should be paid to the question of small-scale versus large-scale investment, and that the question of equity investment versus loan financing, while considered important, should be discussed at the forthcoming third Seminar to be held in Sydney, Australia in 1978. With regard to taxation, special attention will then be paid to tax incentives, double taxation and profit shifting, including transfer pricing.

## 3. Taxation and Customs Cooperation Conference (TCCC)

The Taxation and Customs Cooperation Conference (TCCC) is an informal sub-regional grouping of Asian countries — Republic of China (Taiwan), Republic of Korea, the Philippines and Republic of Vietnam — originally meeting on a periodic basis in order to substantiate the desire of the member countries for regional cooperation in the exchange of information on taxation and on customs matters.

The TCCC was the result of an agreement reached at ministerial level by the four nations in Washington, D.C., in September 1971.
The four member countries have had four meetings at which the main topics discussed were as follows:

*I. Taipei, May 30—June 2, 1972*

- A. Taxation:
  1. General Discussion on Tax Conventions
  2. Mutual Exemption of Taxes on Income from Sea and Air Transportation
  3. Establishment of an Asian Center for Tax Administrators
- B. Customs:
  1. Multilateral Agreement on the Suppression of Customs Fraud in Respect of Exchange of Information Relating to Smuggling Activities and Falsification of Commerical Documents
  2. Exchange of Regular Visits of Customs Officials to Become Familiar with Up-to-Date Customs Procedures and Practices of the Participating Countries.

*II. Manila, June 25—July 3, 1973*

- A. Taxation:
  1. Tax Treatment of Foreign Investments
  2. Tax Treatment of Tourism
  3. Automatic Data Processing for Tax Administration
- B. Customs:
  1. Removal of Tax Barriers to Promote Trade Among Member Countries
  2. Problems of Administration and Simplifying Documentation and Procedures in Customs

*III. Saigon, October 29—November 3, 1974*

- A. Taxation:
  1. Problems and Experiences in Tax Auditing
  2. Tax Potentials Related to the Agricultural Sector
- B. Customs:
  1. Customs Service to Promote Tourism
  2. Incentives to Export Trade

*IV. Seoul, June 9—15, 1975*

- A. Taxation:
  1. The Operation of the Global Income System
  2. The Improvement of the Indirect Tax System — Introduction of the Value-Added Tax
  3. Training of Tax Official
- B. Customs:
  1. Customs Cooperation in the Field of Valuation

1. See Report of ESCAP Seminar held in Manila, November—December 1974, and country reviews up to 1976. Economic and Social Commission for Asia and the Pacific. Bangkok 1976; Report of ESCAP Seminar held in Tokyo in September/October 1976 and country papers of Seminar. Economic and Social Commission for Asia and the Pacific. Bangkok, 1977; Bulletin for International Fiscal Documentation 1977/1 at 40.
2. Further details upon request.

2. Cooperation Among Member-Countries for Narcotics and Smuggling Control
3. Export Promotion Policies by Customs and Tariff Measures

Papers prepared by member countries on the main topics have been published in the Report of Proceedings of the Taxation and Customs Cooperation Conference by the host country for distribution to the participant countries.

Those documents are thus only available to the countries which took part in the conference and are therefore not subject to wide dissemination. However, the library of the International Bureau of Fiscal Documentation possesses the Report of Proceedings of TCCC.

The fall of the Republic of Vietnam and other major political developments in the member countries have had a profound effect on the future existence of the TCCC. It should be noted that during the fourth conference in Seoul, not only was the Republic of Vietnam not represented but the site for the 5th TCCC was not formally fixed.

# NEW ZEALAND: 1977 Budget Proposals*

Brief details relating to the various taxation proposals follow—

We must stress that the items covered are only proposals at this stage. They have no legal effect until incorporated into legislation later this Parliamentary Session.

### Depreciation

#### Shift work depreciation allowances

A special depreciation allowance in addition to the ordinary rates of depreciation will be allowed in the second to fifth years of life of qualifying existing, new or second hand plant and machinery which is used on a shift work basis. The allowance will be:

o Two-Shift Operation:
3 percent d.v. where the plant and machinery is used for at least 4,000 hours a year (80 hours a week).

o Three-Shift Operation:
A further 3 percent d.v. where the plant and machinery is used for at least 6,000 hours a year (120 hours a week).

Example:

| | one shift | two shifts | three shifts |
|---|---|---|---|
| Ordinary Depreciation | 10% | 15% | 15% |
| Special Allowance | Nil | 3% | 6% |
| Total Depreciation (d.v.) | 10% | 18% | 21% |

The new allowance will take effect from the income year commencing 1 April 1978. This means that plant and machinery for which the 1978/79 year is the second, third, fourth or fifth year of operation will qualify for this new allowance.

### Depreciation limit on motor cars

The "cost" of motor cars for depreciation purposes will be increased to $7,000. This new limit will apply to cars purchased during the income year which commenced on 1 April 1977.

### Donations and school fees

The existing special exemption will be converted into a rebate of 50 percent of qualifying payments, subject to a maximum rebate of $175.
The new rebate will take effect with the income year commencing 1 April 1978.

### Energy conservation

Beginning with the current income year ending 31 March 1978, approval of the deductibility of capital energy expenditure will be undertaken by the Commissioner of Inland Revenue instead of the Commissioner of Energy Resources.
It is proposed to amend section 125 of the Income Tax Act to specify the kinds of ca-

* **Published by the Office of the Commissioner of Inland Revenue in Public Information Bulletin No. 91 of September 1977.**

pital energy expenditure, apart from any which may from time to time be added by Order in Council, that will be eligible for 100 percent write-off in the year incurred instead of on the slower depreciation basis that would otherwise apply.

### *Export incentive*

The Budget announcement embodies a proposal for a new incentive scheme based upon net overseas exchange earnings as well as the continuance of the present incentives to the existing terminating dates. Before the Government makes any final decision on a new scheme, discussions will be held with interested parties.

### *Family assistance*

The proposal is in three parts—
- o Extension of the Young Family Rebate
- o Introduction of a new Single Income Family Rebate
- o Adjustment of the spouse rebate

All elements will apply retrospectively from 1 April 1977.

#### Young family rebate

Details of the proposals are—

o The annual rebate will be increased from $312 ($6 per week) to $468 ($9 per week).

o Principal income earners with an income of not more than $7,800 ($150 per week) will receive the full benefit.

o Rebate will abate at 10c for each $1 of income in excess of $7,800, so as to be extinguished when the income reaches $12,480.

The extended and increased rebate applies to children under five years of age and is allowed through the PAYE system from 1 October 1977.

Taxpayers whose earnings are between $140 and $240 a week who qualify for this rebate for the first time will need to complete a supplementary tax code declaration which will be available from all Tax and Post Offices in order to receive the benefit from 1 October.

Those taxpayers currently operating an S + F or M + F Code will automatically receive the increased rebate.

New tax deduction tables incorporating the revised rebate will be posted to the employers before 1 October.

#### Single income family rebate

This will be allowed on an end-of-year basis only, and will not be built into the PAYE tax deduction tables.

o The rebate will be allowed to the principal income earner.

o The full year's rebate will apply to a child who was under 10 years of age at any time during the year ending on 31 March.

o Only one rebate can be claimed no matter how many children under 10 years of age are supported.

o The child must be supported by the claimant and be one for whom the family receives a family benefit.

o The rebate will be $208 reduced by 30c for each $1 of spouse's income in excess of $1,040, so that—

o No rebate will remain where the spouse's income exceeds $1,733.

o The rebate will also be allowed to persons in an established de facto relationship meating the criteria.

o Solo parents would also qualify for the rebate.

o Unlike the Young Family Rebate, there is no abatement in respect of the Principal Income Earner's income.

o The rebate is additional to the Young Family Rebate. Those persons with a child under 5 years of age may therefore qualify for both family rebates.

#### Spouse rebate

This is a minor adjustment which—
- o Increases the rebate to $156
- o Increases the income limit to $520
- o Amends the abatement to 30c for each $1 excess income, so as to eliminate the rebate at a spouse's income of $1,040.

Note: The Single Income Rebate starts to reduce only when the spouse rebate has been fully abated.

### *Farming industry*

#### Livestock incentive scheme

The Government has decided that there will be a reduction in the number of minimum stock units which the farmer must achieve and sustain to qualify for either the suspensory loan or tax deduction incentive. This reduction will be retrospective to the introduction of the scheme.

#### Development expenditure

The existing incentive will be extended in respect of qualifying expenditure incurred up to and including the year ending 31 March 1979.

### *Fishing industry*

#### Loans for fishing vessels, gear and equipment

This involves an extension of the existing suspensory loan scheme to the purchase of new fishing vessels built in New Zealand. Until a loan is converted to a grant it will be ignored for tax purposes and the taxpayer's entitlement to deduct expenses or claim depreciation or investment allowances will be unaffected.

If a loan is converted into a grant the amount remitted will be deemed to be assessable income derived in the year remitted or that year plus up to two immediately succeeding years.

#### Fishing boat ownership accounts

It is proposed that an ordinary fishing boat ownership account, akin to the ordinary farm ownership account available to prospective farmers, be made available to prospective fishermen, through any branch of an authorised savings institution. Increases in the savings account will qualify for a tax rebate of 45c in the $ up to a maximum increase of $4000 for any one year and a maximum aggregate of $50,000 in any one account.

#### Development expenditure

The present taxation provisions for development expenditure on rock oyster, mussel, longline mussel, and fresh-water fish farms due to expire on 31 March 1978 will be extended for a further 12 months.

### *Forestry industry*

Farmers who have established farm woodlots under the Forestry Encouragement Loans Scheme of 1962 may be permitted by the Forest Service to convert from that scheme to the Forestry Encouragement Grants Scheme 1970.

After the conversion, the farmer's subsequent expenditure on the woodlot will

o Be eligible for a non-taxable grant from the Forest Service, equal to one-half of qualifying expenditure.

o Not be deductible for tax purposes in the year incurred.

o Not be deductible from the proceeds on disposal of the woodlot unless, and then only to the extent that, the expenditure incurred exceeds twice the amount of the grant.

### *Interest*

#### (1) Direct lending on housing

The additional $200 exemption for interest received by individuals from the Post Office Savings Bank, Trustee Savings Bank, private Savings Banks and Building Society deposits is extended from 22 July 1977 to interest received from a mortgage guaranteed by the Housing Corporation in terms of the Mortgage Guarantee Scheme. To be eligible for guarantee a mortgage must meet specific conditions as to term, interest rates and purpose of loan.

#### (2) Farm vendor mortgages

From 1 April 1978, 50 percent of the mortgage interest derived in any income year by a retiring farmer will be exempt from income tax without any upper limit where he or she sells the farm to a young farmer approved by the Rural Bank and leaves 50 percent of the purchase price on first mortgage for at least 7 years at Rural Bank interest rates.

It is not expected that interest subject to this 50 percent rebate will also qualify for either the rebate under the "Vendor Mortgage" or the exemption under the "Direct Lending" Scheme.

#### (3) Vendor mortgage scheme

This "home vendor/mortgage" interest rebate scheme provides an income tax incentive to encourage older people to vacate large family homes and move into smaller units.

In terms of the scheme, which will be administered by the Housing Corporation, an income tax rebate of $500 in any one year will be allowed on the mortgage interest derived from 22 July 1977 by an older person where he or she sells and vacates a large family home and leaves 50 percent of the Government Valuation on a guaranteed first mortgage for at least 7 years at a maximum interest rate rate of 10 percent per annum.

It is not expected that interest qualifying for this rebate will also qualify for either the exemption under the "Direct Lending" Scheme or the rebate under the "Farm Vendor" Scheme.

4) Inflation adjusted savings bond

. taxpayer investing in the new stock, hich will be non-transferable, will derive ncome in two ways

- Interest at 2 percent per annum on the riginal purchase price. This will be taxable nd qualify for the $100 interest exemption.
- An amount payable on redemption of he stock, equivalent to the movement in he Consumer Price Index applied to the riginal purchase price with a minimum increment of 5 percent per annum. This income will be exempt from tax.

*leat freezing industry assistance*

pecial grants are to be given as temporary ssistance until such time as the Industry is a position to lodge development plans or the purposes of the "up to 40 percent" nvestment allowance under section 121. t is proposed that any item of plant and achinery in respect of which a grant has een received under the temporary scheme ill not also qualify for investment allowances.

irants will not be taxable but will reduce he cost price of the assets for depreciation urposes.

*ay-period taxpayers — National superannuitants*

or 1978 and subsequent years those New ealand residents whose only income is om national superannuation will not be equired to file annual returns of income. he tax deducted at source will cover their nnual liability unless they elect to file a eturn to obtain the benefit of special exmptions or rebates not provided for in the AYE tables.

*Rates rebate on owner-occupied homes*

- Commencing with the income year 1 April 1978 — 31 March 1979 an income ax rebate of up to $25 will be allowed to he principal income earner of a family in espect of local authority rates on owner-occupied homes.

For example: Rates: $20 — Rebate $20
Rates: $40 — Rebate $25

- Qualifying rates will be the balance remaining after deducting the amount of any reimbursement (such as on sale of the residence) or any rebate (such as that given by local authorities under the rate relief scheme for low income earners) or any portion otherwise deductible for income tax or Property Speculation Tax purposes.
- The rebate will be claimed and allowed on an end-of-year basis when the annual tax return is furnished by the taxpayer.

*Regional development*

Regional development — Establishment grant scheme

This scheme is designed to provide a contribution by Government towards the cost of feasibility studies, initial or "pilot" production and marketing costs of manufacturing and processing projects which locate in priority regions or other slow growth areas.

The maximum grant payable by the Department of Trade and Industry for any one project will be $10,000. It will not be assessable, but any expenditure incurred in the project will be allowable as a deduction for tax purposes and will be reduced by the amount of any grant.

Regional development pioneer incentive scheme

This scheme will take the form of a special grant or suspensory loan on new plant and machinery as defined for the purposes of the regional investment allowance.

It is expected that payments under the scheme will not be assessable for tax but any revenue or capital expenditure in respect of which a grant is paid will be reduced for tax purposes by the amount of grant.

Likewise any repayment of a grant or suspensory loan under the scheme, will be allowable as a deduction in the year of repayment.

*Exemptions from stamp duty*

First farm

The exemption will apply with effect to instruments executed after Budget night — that is, where the agreement is executed on or after 22 July 1977. Transfers will remain liable as a deed.

For the meantime until legislation is enacted if it is necessary that a document be stamped, the normal conveyance duty should be paid. If the transaction qualifies, a subsequent refund of duty will be arranged on application being made.

First home

The position here is similar to that for a "first farm".

*Terminating dates*

| Section of Act | | Terminating Date |
|---|---|---|
| 119 | Regional investment allowance | 31 March 1980 |
| 120 | Export investment allowance | 31 March 1980 |
| 121 | Industrial development plan investment allowance | 31 March 1980 |
| 122 | Farming and agriculture investment allowance | 31 March 1980 |
| 123 | Fishing investment allowance | 31 March 1980 |
| 127 | Development expenditure on farming or agricultural land | 31 March 1979 |
| 128 | Development expenditure on rock oyster or mussel farms or freshwater fish farms | 31 March 1979 |
| 154(2) | Export-market development expenditure | 31 March 1980 |
| 154(3) | Tourist-promotion expenditure | 31 March 1980 |
| 155 | Export-market development by self-employed persons | 31 March 1980 |
| 156 | Increased exports | 31 March 1980 |
| 157 | Increased exports to new markets | 31 March 1979 |
| 158 | Export qualifying services | 31 March 1980 |
| 171 | New markets export development grants | 31 March 1980 |

Note that the terminating date for the various investment allowances and the range of export and tourist incentives remain unchanged.

*Interest from building societies*

As from 1 April 1977 interest received by individuals from Building Societies qualifies for the "additional" $200 exemption.

# Genèse et Motivations d'une Réforme Fiscale ~

## Le cas de la loi française portant imposition des plus-values

## Première partie

par Jean-Loup Hay *

### I. INTRODUCTION

*La France a vécu en 1976 un des épisodes importants de l'histoire de son système fiscal: elle s'est doté, non sans peine, d'un nouveau régime d'imposition des plus-values.* [1]

*L'évènement est mémorable dans ce pays où toute modification des situations acquises est fréquemment perçue comme une atteinte aux droits fondamentaux et, où l'attachement à la propriété privée fait sans cesse reculer la perspective d'un avènement d'une fiscalité plus équitable et rationnelle.* [2] *Il l'est sans doute aussi par le fait qu'il a quelque peu modifié l'échiquier politique, révélé aux français certaines tensions jusqu'alors dissimulées entre les pouvoirs exécutif et législatif et mobilisé, outre les grands ténors de la politique habitués à l'arène parlementaire et à ses joutes oratoires, les membres des milieux intellectuels et professionnels les plus aptes à donner à la loi ses caractères d'équité et d'efficacité ou à en prévoir certains effets.*

*Durant toute la période d'élaboration du texte, longue d'environ dix-huit mois, un vaste débat public s'est instauré selon le voeu même du Président de la République. Il en est résulté une évolution progressive des idées et des modalités techniques retenues à l'origine, en même temps qu'un affinement ou une plus grande complexité de certaines de ces dernières. A certains égards, les objectifs poursuivis ont quelques fois été perdus de vue.*

*L'objet du présent article — qui suppose la connaissance des dispositions contenues dans la loi — est justement, en premier lieu, de rappeler quelles motivations guidaient les inspirateurs de la réforme, en particulier le Président de la République.*

*Il est, en second lieu, de montrer comment les divers organismes concernés par l'élaboration du texte de loi ont répondu à l'attente présidentielle et de mettre en évidence les raisons pour lesquelles ils proposèrent telle ou telle modification.*

*Il est enfin, en troisième lieu, de souligner l'impact qu'a pu avoir le Parlement français qui ne s'est pas contenté de discuter la projet de loi mais, sous l'influence conjuguée d'un exécutif fort insistant et de quelques campagnes de presse virulentes, le transforma assez profondément.*

### II. LES VOLONTES DU POUVOIR EXECUTIF

Dans la lettre qu'il adressa le 25 juillet 1974 à son Premier ministre, le Président Giscard d'Estaing marquait très nettement son intention d'accroître le degré d'équité du système fiscal français en modifiant la notion de "revenu imposable". Pour y parvenir, il demandait son élargissement à l'ensemble des plus-values de toute nature, ce qui revenait à assimiler certaines sources d'enrichissement sans travail à des revenus.

Pour un homme politique soucieux de "*conduire le changement*" et de parvenir à *l'unité par la justice*, une telle réforme présentait notamment l'avantage de construire plus rapidement une société sans privilèges. L[e] principe en était la mise à contribu[tion] des "plus-values constitutive[s] d'un revenu véritable" qui ne son[t] justifiées "ni par le travail au gran[d] jour, ni par le talent"; c'était don[c] faire oeuvre de justice. [3]

Déjà, lorsqu'il était ministre des fi[-]nances du gouvernement Messmer, V. Giscard d'Estaing avait procédé à certains ajustements ponctuels visan[t] à moraliser la fiscalité relative au[x] gros revenus. La préparation du budget pour 1974 avait par exempl[e] donné lieu à l'adoption de trois type[s] de mesures, dont l'une proposai[t] d'inclure aux revenus les plus-value[s] réalisées de façon systématique. [4] Il savait alors fort bien que la fiscalité est un des moyens privilégiés d[e] faire progresser la justice sociale et pensait aussi que l'opinion publiqu[e] française est plus hostile à une taxation directe du patrimoine priv[é] qu'à l'élargissement de la base imposable au titre de l'impôt sur le revenu. [5] Ceci explique que, nouvellement élu à la Présidence de la Répu[-]

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* Assistant à l'Université de Nice et au Centr[e] d'Etudes Fiscales Internationales.

1. Loi No. 76-660 du 19 juillet 1976 por[-]tant imposition des plus-values et création d'une taxe forfaitaire sur les métaux précieux, les bijoux, les objets d'art, de collection et d'antiquité, J.O. du 20 juillet 1976.
2. La France dispose encore aujourd'hu[i] d'un système fiscal dans lequel les impôts liés à la production et à la dépense de consommation occupent la première place. La part de ces impôts dans le total des recettes fiscales et des cotisations sociales est en effet de l'ordre de 40 pour cent alors qu'elle n'est que l'ordre de 30 pour cent dans la majorité des autres pays membres de la C.E.E.; or, on sait que ces impôts ne sont nullement assis en fonction des capacités contributives des individus.
3. V. Giscard d'Estaing, DEMOCRATIE FRANÇAISE, Paris: Fayard, 1976, pp. 60-61.
4. Les deux autres mesures visaient au renforcement de la lutte contre la fraude fiscale et à augmenter les avantages consentis aux contribuables modestes tout en réduisant ceux accordés aux plus riches. Voir sur ce point: "Les nouvelles dispositions fiscales applicables en 1974", Loi de Finances pour 1974, Mesures nouvelles, DGI, Notes bleues du Ministère des Finances, Diffusion 1/74/6, pp. 2-7; "La politique économique et la politique budgétaire", exposé de V. Giscard d'Estaing devant l'Assemblée nationale, 23 octobre 1973, Allocutions ministérielles, Notes bleues, diffusion 11/73/2, pp. 24-25.
5. A en croire le sondage SOFRES paru dans le "Nouvel Observateur" du 17 au 23

blique, V. Giscard d'Estaing montra quelque hâte à demander à son gouvernement la mise à l'étude d'un dispositif d'imposition généralisée des plus-values, profitant ainsi de ce que les français avaient été sensibilisés au problème durant la campagne électorale.

On est aussi en droit de penser que le Conseil des Impôts anticipait en quelque sorte la demande présidentielle en faisant figurer, dans son deuxième rapport, une brève étude comparative des éléments de droit fiscal relatifs aux systèmes anglais et américain qui allait permettre au gouvernement d'insuffler une orientation typiquement française au projet de réforme. 6

S'inspirant sans doute des observations faites dans ce document officiel assuré d'une assez large publicité, le ministre de l'économie et des finances, J.-P. Fourcade, indiquait dans sa lettre du 3 février 1975 à A. Monguilan, qu'il chargeait de présider la commission d'étude, les caractéristiques que devrait présenter l'impôt:

1. Avoir pour fait générateur, la *réalisation* de la plus-value,
2. Ne frapper que la *plus-value réelle* en exonérant totalement celle résultant de la hausse des prix, i.e. la plus-value nominale,
3. Réaliser *l'inclusion de la plus-value imposable dans l'assiette soumise à l'impôt sur le revenu.*

Ainsi, comme dans la quasi-totalité des systèmes d'imposition des plus-values en capital, l'option prise par le ministre — selon le voeu du Président de la République —, consistait-elle à ne frapper que les plus-values accusées par un actif déterminé au moment de son *aliénation* et à ne pas s'intéresser à *l'enrichissement* résultant de la seule *disposition* du même actif ou d'un patrimoine. D'autre part, à l'inverse de ce qui se pratique aux Etats-Unis et en Grande-Bretagne, l'érosion monétaire devrait être prise en compte et les barèmes de l'impôt sur le revenu (éventuellement, une tarification forfaitaire) s'appliquerait à la plus-value imposable. On sait en effet que dans ces pays, le législateur n'admet aucune réduction pour tenir compte de la plus-value, l'assiette de la "capital gains tax" étant le montant de la plus-value nominale, et que l'imposition est établie soit à *taux uniforme* — respectivement 35 pour cent et 30 pour cent —, soit au *taux marginal* de "l'income tax", en vertu du mécanisme de "l'alternative tax".

Les directives données par le ministre dans sa lettre de mission se retrouvent d'ailleurs dans le "Projet de loi portant imposition des ressources provenant de plus-values assimilables à un revenu" présenté par J.-P. Fourcade et Ch. Poncelet lors d'une conférence de presse tenue le 20 avril 1976, soit une semaine après que le

## FRENCH CAPITAL GAINS TAXATION – THE ORIGIN OF AND THE REASONS FOR A NEW TAX REFORM

The Editors of the Bulletin are pleased to present an article by Mr. Jean-Loup Haÿ describing the reasons for the introduction of a capital gains tax on private individuals in France and the ensuing parliamentary struggle to have the new legislation enacted.

It should be appreciated that in Western Europe the taxation of non-business capital gains is generally the exception rather than the rule. Only a few governments, such as Sweden and the Swiss Canton of Solothurn, include capital gains in their normal income taxes. Other countries, such as Ireland and the United Kingdom, also subject capital gains to income tax but under special separate capital gains taxes. However, most Western European countries do not subject capital gains as such to income tax, but only impose tax on certain gains, for example speculation gains derived from the disposal of real or personal property which has been held for a relatively short period of time and the sale of a major participation in a company.

France is the first country in the EEC to introduce legislation integrating capital gains taxation in its normal income tax. The basic idea underlying the new French capital gains taxation is that in the present society capital gains constitute, just as "normal" income, a source of income, of purchasing power, for its recipient. If this assumption is true it seems to be fair that persons who receive such capital gains should also contribute their share of income tax. However, capital gains tax when it was proposed in France did not meet with much approval, in particular not in those circles which saw their prospects of obtaining future gains reduced. The introduction of the Bill triggered off a nation-wide discussion which lasted for about eighteen months; when the Bill was finally passed it was so much amended and watered down that Mr. Cozian, a well-known French tax professor, complained that "the mountain had given birth to a mole hill" (in DROIT FISCAL 1976, p. 750).

Mr. Haÿ's article presupposes a certain familiarity with the present French capital gains tax, details of which can be found in the French language in the April 1977 issue of the *Bulletin* (M.-H. Brochier and J.-P. Allavena, Nouveau régime d'imposition des plus-values en France) and in English in the July 1977 issue of *European Taxation* (D.A. van Waardenburg, France: The new individual capital gains taxation). Mr. Haÿ describes in detail how in 1974 President Giscard d'Estaing prepared the field for a general capital gains tax, which Committees have been consulted and which of them have prepared reports. These reports are often also internationally important since they solve fundamental questions which are inherent to capital gains tax and they may have substantial value for the solution of similar problems in other European countries should these also contemplate the introduction of a general capital gains tax.

D.A. van Waardenburg

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mars 1975, No. 540, p. 55, 59 pour cent des personnes interrogées sont d'avis que la plus-value est normale et qu'elle doit bénéficier entièrement au propriétaire. 17 pour cent seulement pensent qu'elle doit être soumise à l'impôt sur le revenu quand le bien est vendu.

6. Cf. "Rapport au Président de la République", Conseil des impôts, juillet 1974, Paris: Journaux officiels, pp. 67-72.

Conseil des ministres l'eut approuvé. [7]

A cette occasion, les présentateurs devaient souligner que le texte, composé de 12 articles, avait pour ambition d'assurer une répartition plus équitable des charges communes et répondait aux principes de *justice* et de *modération*. Conformément au premier principe, le projet prévoyait l'exonération des plus-values réalisées à l'occasion de la cession d'une résidence principale ou dans le cadre d'une activité commerciale, artisanale ou agricole; déjà, une distinction y est faite entre trois catégories d'opérations imposables:

— d'une part, les ventes intervenant moins de deux ans après l'acquisition pour lesquelles la plus-value est assimilée à un revenu et se trouve soumise aux règles de droit commun,

— d'autre part, les ventes réalisées plus de deux et moins de dix ans après l'acquisition qui permettent l'atténuation de la taxation par revalorisation du prix d'acquisition et par division de la plus-value en cinq parts,

— enfin, les ventes effectuées après un délai de plus de 10 ans donnant droit, en plus des avantages réservés aux ventes à moyen terme, à l'application d'un taux de réduction de 3,33 pour cent par année de détention après la dixième, ce qui conduit à une totale exonération de plus-values après un délai de 40 ans.

Conformément au second principe, le gouvernement accordait aux futurs contribuables quelques abattements et exonérations et s'efforçait de ne pas leur imposer des contraintes fiscales et des servitudes administratives trop lourdes. Il poursuivait donc un but de modération mais aussi de simplicité parce qu'il entendait garantir que l'impôt n'ait aucun effet dissuasif à l'encontre des propensions individuelles à l'épargne et de l'effort d'investissement nécessaires à la croissance économique de la France.

## III. LES PREFERENCES DES ORGANISMES CONSULTES

Pour élaborer son projet de loi, le gouvernement Chirac avait à sa disposition (1) l'opinion émise par la Commission des inégalités sociales, (2) les recommandations formulées par la Commission d'étude d'une imposition généralisée des plus-values, (3) l'avis voté par le Conseil Economique et Social. Présidée par J. Méraud, la Commission des inégalités sociales, réunie pour la préparation de l'orientation préliminaire du VIIe Plan, remettait en mars 1975 un rapport — couramment appelé Rapport Méraud — dans lequel elle proposait un certain nombre d'orientations d'ordre économique, social et fiscal. Elle envisageait, par exemple, de "compléter l'action de réduction de l'éventail des revenus primaires par une redistribution plus efficace et plus juste" en concentrant l'effort sur la réforme de l'imposition des revenus des personnes physiques, des droits de succession et des impôts locaux. [8]

En ce qui concerne plus particulièrement la taxation des plus-values, la commission Méraud avait été conduite à suggérer la *déductibilité des moins-values* sur les plus-values rattachées aux mêmes catégories de biens. Elle proposait également que l'intégration de la plus-value imposable soit *étalée dans le temps*, de manière à ce qu'elle ne dépasse pas une fraction déterminée du revenu annuel dont le contribuable concerné a habituellement la disposition.

La première proposition fut ensuite très longuement discutée et le solution très restrictive et discriminatoire à laquelle s'est rangé le législateur [9] dénote sans doute son intention de ne pas pénaliser ou effrayer les détenteurs de valeurs mobilières, déjà atteints par la tendance baissière constatée sur le marché boursier, mais aussi, la volonté du ministre des finances de limiter très strictement les déductions de moins-values, pour éviter la pratique de l'évasion fiscale qui aurait contribué à minimiser les recettes attendues.

La seconde proposition, tendant à l'étalement de l'impôt et à éliminer des phénomènes de "surprogressivité", fut reprise, sous des formes différentes, par la commission Monguilan et par le Conseil Economique et Social pour n'aboutir, finalement, qu'à l'adoption du "Quotient quinquennal" qui atténue la progressivité de l'impôt sans cependant assurer un véritable étalement. [10]

Constituée par un arrêté ministériel du 11 février 1975 et rattachée au ministre de l'économie et des finances, la commission d'étude d'une imposition généralisée des plus-values — commission Monguilan — avait pour tâche d'examiner les modalités de l'impôt projeté. Elle se composait de huit membres appartenant à des secteurs socio-économiques très divers et d'un rapporteur, J. Delmas. En six mois environ, elle procéda à l'audition de plus de cent personnalités à même de l'aider dans son travail et se livra à la mise au point et à l'examen des modalités d'imposition susceptibles de correspondre aux directives données par le ministre de tutelle. Le document établi par le rapporteur, et remis au ministre par le Président Monguilan le 28 juillet 1975, contient non seulement l'esquisse d'un système d'imposition répondant aux caractères indiqués, mais aussi, pour diverses modalités techniques le composant, des options et des variantes possibles sur lesquelles la commission n'a pas pu ou voulu se prononcer. Sont annexés au rapport proprement dit, de nombreux documents émanant de la Direction générale des impôts, du Comité d'étude pour la réforme de l'entreprise et dela Commission Méraud. Dans sa présentation actuelle, le tome deux regroupe les opinions et les rapports recueillis par la commission auprès d'une cinquantaine de personnes entendues par elle. [11]

Conformément au désir qu'exprima le Premier ministre dans la lettre du 15 octobre 1975, l'ensemble des propositions faites par la commission Monguilan fut ensuite soumis au Conseil Economique et Social. Le bureau de cette assemblée en saisit la section des finances constituée en son sein qui devait désigner son rapporteur en la personne de P. Uri. [12]

7. Conférence de presse tenue le 20 avril 1976, Mesures nouvelles, Notes bleues, DGI, diffusion 4/76/3.

8. "Rapport de la Commission des Inégalités Sociales", Paris: La Documentation Française, Mars 1975, pp. 54-60.

9. Voir à l'article 7-II de la loi du 19 juillet 1976.

10. Article 4-IV de la loi et article 18 du décret No. 76-1240 du 29 décembre 1976 fixant, pour les biens autres que les valeurs mobilières, les conditions d'application de la loi du 19 juillet 1976 portant imposition des plus-values, J.O. du 30 décembre 1976, p. 7637.

11. *L'imposition des plus-values*, rapport de la commission d'étude, Paris: La Documentation Française, 2 tomes, 1975.

12. Voir le "Rapport présenté au nom du Conseil Economique et Social par M. Pierre

Le travail consistait donc, pour ce dernier, à élaborer un rapport à partir de celui présenté par la commission Monguilan et, pour le Conseil, à le discuter puis à procéder à un vote tant sur l'ensemble du projet d'avis que sur les quelques amendements qui lui furent proposés.[13]

Ainsi, après l'austère travail d'innovation auquel s'était consacré la commission Monguilan en construisant de toutes pièces un système typiquement français d'imposition généralisée des plus-values respectant les directives et orientations gouvernementales, le Conseil inscrivait ses propres réflexions et propositions dans le cadre de la logique et de la cohérence.

Sur la plupart des points qu'elle évoqua, la commission Monguilan fit part de ses préférences après avoir mené une analyse permettant de faire apparaître les solutions envisageables et à en discuter les inconvénients et mérites. Les différentes modalités du système qu'elle a proposé, et qui répondent aux directives ministérielles contenues dans la lettre de mission, figurent dans le tableau I.

En regard de chacune de celles sur lesquelles le Conseil s'est prononcé, son avis ou sa recommandation est porté dans la partie droite du même tableau.

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Uri", in J.O., Avis et rapports du C.E.S., Année 1976 No. 4, 26 janvier 1976, pp. 135-159.

13. L'avis fut adopté au cours du premier scrutin par 81 voix contre 64 et 24 abstentions. Le second scrutin portait sur un amendement "tendant à préconiser une taxation annuelle du capital, dont l'un des avantages serait d'apporter à celle des plus-values une simplification théorique et pratique considérable. Cette proposition faite par le groupe la C.F.D.T. fut repoussée par 108 voix contre 45 et 15 abstentions. Six autres scrutins portaient sur des aménagements divers du système.

**TABLEAU I — Les recommandations des organismes consultés en matière d'imposition des plus-values**

*I. CHAMP D'APPLICATION DE L'IMPOSITION*

| Modalités techniques | Le système d'imposition généralisée de plus-values conçu par la Commission Monguilan | Les avis formulés par le Conseil Economique et Social |
|---|---|---|
| 1. *Le fait générateur* | *Principe:* l'aliénation;<br>*Recommandations pratiques:* tenir compte, pour recouvrer l'impôt, des échelonnements de paiement; considérer l'ensemble des réalisations (y compris celles suivies d'un réemploi) des biens acquis à titre onéreux ou gratuit; exclure toute imposition du gain en capital constaté en cas de donation ou de succession et s'ajoutant aux droits de mutation normalement perçus. | Dans le cas de la vente, opération type, retenir le contrat. Ainsi, l'impôt cessera d'être dû en cas de son annulation. Les modalités d'échelonnement du paiement doivent être sans effet. |
| 2. *Les biens imposables* | *Principe:* seulement, mais tous les biens réalisables.<br>*Rec. prat.:* propriété immobilière et assimilée, sauf terrains à bâtir déjà imposés; propriété mobilière, y inclus obligations, devises étrangères, métaux précieux, or, oeuvres d'art...; obligations non indexées et biens situés ou détenus à l'étranger, sous réserve d'application des conventions internationales. | Quatre catégories de biens en cause:<br>1) les terrains et immeubles,<br>2) les valeurs mobilières,<br>3) l'or,<br>4) les objets d'art, antiquités, pierres et bijoux. |
| 3. *Les personnes imposables* | *Principe:* les personnes physiques et sociétés de personnes non passibles de l'I.S. (dites translucides).<br>*Rec. prat.:* a) sont seules visées par la loi des opérations sur patrimoine privé realisées par les titulaires d'activités professionnelles consistant à réaliser de plus-values; marchand de biens et professionnels de la construction; b) règle identique pour les activités industrielles, commerciales, artisanales, agricoles ou libérales: les plus-values sur actifs professionnels restent soumises aux régimes spécifiques aux plus-values professionnelles; c) les plus-values réalisées lors de la cession de tout ou partie de leurs droits, par les personnes détenant une fraction importante des droits sociaux, restent soumises aux dispositions de l'article 160 du C.G.I.; d) les non-résidents seront imposés sur les plus-values qu'ils réalisent en France, sous réserve d'application de conventions; les résidents non domiciliés resteront soumis aux règles relatives à l'impôt sur le revenu (imposition des revenus de source francaise). | Approbation implicite.<br><br>— limiter l'imposition des non-résidents aux plus-values immobilières; l'étendre pour les résidents aux plus-values en France et à l'étranger sous réserve des conventions. |

| Modalités techniques | Le système d'imposition généralisée de plus-values conçu par la Commission Monguilan | Les avis formulés par le Conseil Economique et Social |
|---|---|---|
| 4. *Cas particuliers* | a) en cas d'expropriation pour cause d'utilité publique, la réalisation forcé sera soumise à un régime spécial; b) il n'y aura pas d'imposition dans le cas d'un remembrement urbain ou rural; c) l'exonération pure et simple de la plus-value sur l'habitation principale est préférable, sauf cas d'établissement de l'intention spéculative; d) accepter l'exonération des plus-values procurées par la cession de titres de rente 4,5% 1973 (issus de la conversion de la rente "Pinay" 3,5% 1952-1958) mais aucune exonération de ce genre ne devra être consentie à l'avenir. | a) limiter l'imposition à la partie de plus-value non réemployée, transparence pour celle qui est réemployée; b) transparence pour les remembrements; c) assimiler la vente d'une habitation principale suivie d'un rachat à un échange forcé, d'ou abattement spécial (seuil); d) même position que la commission pour l'emprunt 4,5%,'73. |

## II. *DETERMINATION DE LA PLUS-VALUE IMPOSABLE*

| Modalités techniques | Le système d'imposition généralisée de plus-values conçu par la Commission Monguilan | Les avis formulés par le Conseil Economique et Social |
|---|---|---|
| 1. *De la réalisation à la plus-value nominale* | *Principe:* il y a plus-value si le produit de la réalisation dépasse la valeur d'origine du bien à son entrée dans le patrimoine du contribuable.<br>*Rec. prat.:* produit de la réalisation égal prix de vente stipulé dans l'acte (sauf cas de dissimilation établie) plus frais de réalisation (non inclus l'impôt sur la plus-value) moins valeur d'origine (valeur d'entrée dans le patrimoine majorée des frais d'acquisition, y compris les droits de mutation). Les impenses subies durant la durée de détention seront ajoutées à la valeur d'origine, sauf celles déduites, dans le cadre de l'impôt sur le revenu, du revenu des biens concernés. | |
| 2. *De la plus-value nominale à la plus-value réelle* | *Principe:* la sous-évaluation de la valeur d'origine par rapport au produit de la réalisation contraint à l'actualisation du prix d'achat en le convertissant en monnaie du prix de vente.<br>*Rec. prat.:* la réévaluation se fera sur la base de l'indice annuel général des prix à la consommation des ménages, établi par l'INSEE. | l'Indexation de la valeur de départ en fonction de l'indice INSEE est satisfaisante bien qu'elle puisse conduire à étudier certaines indexations pour l'épargne |
| 3. *De la plus-value réelle à la plus-value imposable* | *Principe:* la spécificité de la plus-value réalisé appelle un traitement spécifique dans le cadre de l'impôt sur le revenu.<br>*Rec. prat.:* opérer un abattement d'un pourcentage uniforme par année de détention en fonction de la nature du bien: au moins 2% pour l'immobilier, 4% pour les actifs mobiliers.<br>*Cas particuliers:* a) pas de traitement particulier pour les biens acquis à titre gratuit; b) prévoir d'ajouter un abattement spécial forfaitaire de 50,000 Francs en cas d'expropriation pour cause d'utilité publique; c) pour les valeurs mobilières, calculer la durée de détention d'après la méthode: "premier entré premier sorti" (First in, first out). | Cette technique appliquée aussi aux moins-values aboutit à l'impasse. |

| Modalités techniques | Le système d'imposition généralisée de plus-values conçu par la Commission Monguilan | Les avis formulés par le Conseil Economique et Social |
|---|---|---|
| 1. *Traitement des moins-values* | *Principe:* les moins values à considérer sont les moins-values réelles à déterminer de la même manière que les plus-values réelles.<br>*Rec. prat.:* recourir au mécanisme de la "déduction banalisée" ou les moins-values sur actifs mobiliers et immobiliers viennent en déduction de l'ensemble des plus-values mobilières et immobilières (sauf pour l'or, les oeuvres d'art, les obligations non indexées et les biens détenus à l'étranger). La moins-value nette éventuelle sera reportée sur les années ultérieures, même sans limitation. | Solution peu satisfaisante dans l'ensemble. Retenir les moins-values à 100%, après correction de la valeur d'entrée pour érosion monétaire. "Déduction banalisée" acceptable (sauf exception mais nécessité de limiter le report sur une durée de 10 années. |
| 2. *Taux applicables à la plus-value imposable* | *Principe:* adopter les principes de personnalisation de l'impôt et de progressivité des taux.<br>*Rec. prat.:* a) rôle du revenu dans le barème: le revenu courant jouera pour moitié (la plus-value reposera sur un "demi-socle"); prendre en considération le quotient familial le plus élevé pendant la durée de détention; b) rôle de la plus-value dans la détermination des taux qui lui sont applicables: pour éviter les phénomènes de "surprogressivité", un quotient annuel sera utilisé par division de la plus-value par le nombre d'années de détention du bien qui en est la source. | Un avantage risque d'être donné à certains contribuables.<br>Le système proposé est en contradiction avec le principe de taxation des plus-values lors de la réalisation; ils est aussi impraticable; le système du quotient annuel est inapplicable aux moins-values et aux plus-values nettes. |
| 3. *Abattement à la base* | *Principe:* admettre un abattement à la base, unique, avant l'intervention des quotients familial et annuel.<br>*Rec. prat.:* abattement proposé: 10,000 Francs. | Système accepté sous condition de rajustement annuel. |

Il apparaît ainsi clairement que la commission Monguilan a eu le souci de dresser un schéma d'ensemble le plus précis possible, tout en oeuvrant dans un "esprit de respect de l'essentiel et de refus des approximations". Cependant, à bien des égards, elle s'est trouvée en quelque sorte gênée par les orientations préliminaires qui lui furent dictées par le ministre des finances. Ces dernières l'ont, d'une part, contrainte à limiter son champ d'investigation et, d'autre part, amenée à élaborer un système qui corresponde aux directives et respecte les règles d'équité, d'efficacité et de cohérence.

Bien des imperfections de notre système fiscal ont ainsi été mises à jour à l'occasion de cette étude. Faute de les avoir expressément recensées en vue de leur éventuelle correction à plus ou moins long terme, elles ont immédiatement provoqué la désapprobation, par le Conseil Economique et Social, de certaines des modalités proposées par la commission; de même, elles ont été à l'origine de bon nombre des amendements déposés sur les bureaux de l'Assemblée nationale et du Sénat.

On doit malgré tout signaler que l'observation par laquelle le commission Monguilan concluait ses développements concernant la détermination des règles d'assujettissement des résidents, non-résidents et domiciliés, allait ouvrir la voie à une réforme importante bien qu'apparamment ponctuelle:
"La commission estime ne pouvoir clore un développement consacré aux limites géographiques de l'obligation fiscale an matière de plus-values sans rappeler que toute nouvelle imposition peut susciter des réflexes d'évasion hors des frontières nationales et une imposition généralisée des plus-values plus que d'autres. Elle pense que le projet du Gouvernement pourrait être l'occasion d'une initiative de sa part, au plan international, tendant à l'harmonisation des législations nationales dans le domaine de la fiscalité personnelle et patrimoniale". [14]

Pour partie au moins, cette invitation n'est pas restée sans suite puisque, au cours du quatrième trimestre 1976, le Parlement français fut appelé à se prononcer sur le "Projet de loi modifiant les règles de la territorialité et les conditions d'imposition des français à l'étranger ainsi que des autres personnes non domiciliées en France". [15] L'objectif essentiel du gouvernement était en l'occurrence d'adopter le critère unique du *domicile* pour régler la situation des personnes physiques au regard des

14. Cf. *L'imposition des plus-values*, op.cit., tome 1, p. 20 , para. 67.
15. Voir Mesures nouvelles, Notes bleues, DGI, diffusion 8/76/4.

textes fiscaux et, de prendre certaines mesures d'accompagnement répondant à un louable souci de modernisation et de normalisation de la législation. Le projet fut à maintes reprises remanié par le Sénat — où il fut d'abord discuté puis adopté le 14 octobre 1976 — et par l'Assemblée nationale; c'est finalement le texte établi par la Commission Mixte Paritaire [16] qui allait être voté simultanément par ces deux assemblées le 20 décembre 1976. [17] A la lecture de l'article 5 de cette loi, concernant notamment les revenus de source français soumis à taxation, en vertu de la loi du 19 juillet 1976 ou de l'article 160 du Code Général des Impôts, on mesurera combien cette réforme était indispensable à l'application du nouveau régime d'imposition des plus-values. Il convient d'ailleurs de remarquer qu'elle est entrée en vigueur le même jour (1er janvier 1977) que les dispositions relatives aux plus-values immobilières votées en juillet 1976.

Par ailleurs, la Commission Monguilan (comme le Conseil Economique et Social) s'est montrée consciente des difficultés auxquelles elle allait inévitablement se heurter à devoir incorporer les plus-values réalisées dans le revenu courant; résolue à faire oeuvre de justice, comme cela lui était demandé, elle risquait alors, par l'élargissement de l'assiette de l'impôt sur le revenu, d'aggraver certaines des iniquités contenues dans la législation relative à ce dernier.

Le risque était d'autant plus évident qu'elle voyait d'emblée son pouvoir de réforme limité à la correction d'une des anomalies du système fiscal français, sans pour autant être autorisée à redéfinir certaines notions de base ou à modifier certaines règles insatisfaisantes à maints égards. Ainsi, à l'inverse de la "Commission Carter" qui aborda le problème de la refonte du système fiscal canadien dans son ensemble et adopta du revenu une conception large et nouvelle [18] — quoiqu'elle s'inspira d'idées développées il y a plusieurs décennies par J.R. Hicks puis par N. Kaldor [19] —, la commission Monguilan devait se contenter d'adapter les modalités qu'elle allait proposer à la législation sur laquelle elle n'avait aucun droit d'action. [20]

Les difficultés auxquelles elle se trouva confrontée n'ont pas échappé au Conseil Economique et Social qui, comme pour souligner les contraintes inhérentes à sa fonction dans le processus d'élaboration du projet, évoqua la possibilité de rattacher les plus-values au capital dans le cadre d'un impôt annuel assis sur ce dernier [21] et celle consistant à abandonner le principe d'annualité de l'imposition des revenus au profit d'un système de moyenne mobile assurant l'étalement sur un nombre d'années déterminé.

Par ailleurs, le Conseil estima qu'il n'avait pas à examiner le bien-fondé de l'imposition prévue par le gouvernement mais rappela malgré tout, d'une part, que les plus-values se distinguent du revenu si celui-ci est conçu comme un flux qui se répète chaque année, alors qu'elles s'y mêlent lorsqu'on le mesure comme la somme de ce qui peut être consommé sans s'appauvrir et, d'autre part, que le droit positif français n'ignorait pas l'imposition des plus-values.

La philosophie du système que recommandait le Conseil dans son avis consistait à établir une relation plus étroite entre l'imposition des plus-values et la composition des patrimoines suivant le niveau du revenu. Le rapporteur de la section des finances de cette assemblée, P. Uri, l'énonçait d'ailleurs aux députés en des termes fort explicites:

"il (le système imaginé par le Conseil) accordait des déductions nouvelles sur les petits revenus; à un niveau plus élevé, où l'investissement principal est constitué par la propriété d'un logement, il offrait un abattement spécial et le bénéfice de la transparence en cas de remploi. A mesure que les revenus s'élèvent et que les patrimoines se diversifient — valeurs mobilières, placements immobiliers — on se rapprochait de l'imposition progressive, mais avec un plafond, tant qu'enfin les opérations professionnelles ou spéculatives fussent taxées sans limite spéciale comme bénéfices industriels et commerciaux". [22]

Pour conclure sa présentation du même système devant le Sénat, P. Uri souligna le fait qu'en généralisant et en unifiant l'impôt, on assurerait son fonctionnement et son rendement tout en évitant les distorsions et les différentiations.

"L'équité s'alliait à l'efficacité et à la simplicité". [23]

16. Elle est réunie à la demande du Premier ministre et est chargée de proposer un texte commun sur les dispositions encore en discussion.
17. Loi No. 76-1234 du 29 décembre 1976 modifiant les règles de territorialité et les conditions d'imposition des Français de l'étranger ainsi que des autres personnes non domiciliées en France, J.O. du 30 décembre 1976, pp. 7630-7631.
18. Rapport de la Commission Royale d'enquête sur la fiscalité, Tome 3: l'imposition du revenu, Ottawa: Imprimerie de la Reine, 1966, pp. 45 et suiv., 57-59.
19. J.R. Hicks, *Value and Capital*, 2e ed., London: Oxford University Press, 1974, Chap. XIV et plus spécialement p. 172. N. Kaldor, *An Expenditure Tax*, London: Allen & Unwin, 1955, pp. 37-46.
20. Il est intéressant de souligner à ce sujet que dans l'exposé qu'il a fait devant les membres de la commission Monguilan, Maurice Allais a souhaité que celle-ci prenne en considération le problème plus général de la réforme d'ensemble de la fiscalité française, cf. *L'imposition des plus-values*, op.cit., tome 2, p. 22.
21. Voir l'Avis du C.E.S., J.O. du 29 janvier 1976, p. 123.
22. Cf. J.O., Débats Parlementaires, Assemblée nationale, Mercredi 2 juin 1976, No. 44 A.N., p. 3574.
23. Cf. J.O., Débats Parlementaires, Sénat, Séance du 6 juillet 1976, p. 2153.

[ à suivre ]

# TAX GLOSSARY

*by H.W.T. PEPPER **

**"D" SCHEME** — At one stage in the administration of British purchase tax an attempt was made to "graduate" the tax where the same articles were sold at different prices reflecting different qualities. Where the price of certain goods fell below designated limits (known as the "D" line) no tax was payable and if the price exceeded those limits tax was payable only on the part of the price which was above the "D" line. The system was finally terminated because of difficulties in administration.

**DAMAGES** — Certain types of damages may be chargeable to income taxes. Where, for example, there is provision in an agreement between entrepreneurs, between employer and employee, etc., for the payment of damages in the event of circumstances arising which would make the agreement less profitable than was envisaged when it was made, such payments would ordinarily be taxable. On the other hand, purely personal damages, e.g., for slander, libel or defamation, would not be taxable. A fairly recent development in Britain has been the taking of tax into account in fixing the quantum of damages in cases of injury or disablement where the damages have been based on the loss of future earning power.

**DANEGELD** — A defence levy on land and real property which was originally made by Ethelred II (the "Unready") to raise money in order to pay Danish raiders to keep away from the coasts of England. The tax was continued as a land tax in subsequent reigns, including that of the Danish ruler, Canute.

**DE MINIMIS** — Sometimes the full rigour of the tax law is not enforced, particularly in the case of a very small amount of tax which has been underassessed or underpaid. The legal phrase in such cases is "de minimis non curat lex" (the law does not take account of trifles), which also applies to cases where a Court makes no ruling where it considers the subject matter too trivial.

**DEATH** — For tax purposes the date of a person's death is the date of cessation of his business, profession, or employment, and the date of disposal of his assets. In some tax codes, capital gains tax becomes payable on death, where the value of an asset at that date exceeds the original cost to the deceased. Where DEATH DUTIES (q.v.) are payable on the value of the asset, the combined liability to capital gains tax and death duty may exceed the value of the asset.
The alternative treatment (adopted, e.g., in Britain) is not to treat transfer on death as a taxable disposal, but to take the value at the date of death as the starting point for capital gains computations in the event of future disposal by a beneficiary.
Under income tax codes which grant personal reliefs to single and married persons, the death of the husband during the tax year may involve two assessments, the first on the husband on the income to the date of death, and the other on the widow for the rest of the year's income. The widow may then be granted an additional personal relief for the part of the year during which she was a widow.

**DEATH DUTIES** — The generic term applied to taxes upon the death of an individual which may also be termed "estate duty", transmission or mutation tax, inheritance, legacy, or succession taxes. Death duties are a form of capital levy payable once in a taxpayer's lifetime, i.e., at the moment his life ends. Such duties are usually calculated on a graduated scale either on the total value of the estate ("estate duty") or on the amount inherited by each beneficiary ("succession duty").

**DECALAGE D'UN MOIS** — The time lag of one month which occurs under the French V.A.T. system in granting credit for tax on materials and services bought in during one month, which may only be set against tax on sales made in the following month.

**DECLARATION** — The statement or "return" a taxpayer makes annually of his income and other matters relevant to income tax, or of his sales or deliveries of goods and other relevant information in the case of sales taxes. The term also has, of course, a non-technical meaning covering anything a taxpayer may state or declare in connection with taxes or duties of any kind.

**DECLINING BALANCE METHOD** — (of computing depreciation, e.g., as used in Japan and the U.S.A.). See REDUCING BALANCE METHOD.

**DEDUCTION AT SOURCE** — A system of deducting or withholding tax, especially income tax, when income is paid by one person to another. For example, tax may be deducted when a dividend is paid to a shareholder by the company which declares it, and tax may be similarly deducted by the borrower when paying interest on his loan to the lender. The tax due from employees on their remuneration may be deducted under PAYE (q.v.) or other schemes by the employer on pay-days. Such deductions are made in accordance with provisions of the tax law which also require the amounts deducted to be accounted for by the person who makes the deduction.

**DEED OF ARRANGEMENT** — When a person is in financial difficulties he may sometimes avoid bankruptcy by making an "arangement" with his creditors, which often takes legal form. Any transfers of the person's assets to trustees (which may be temporary, and be followed by their later return) is usually ignored for the purposes of income tax and capital gains tax. If the asset is subsequently disposed of finally by the trustee on behalf of the person concerned, the final disposal will normally be taken into account in computing tax liability.

**DEED OF COVENANT** — See COVENANT.

**DEELNEMINGSVRIJSTELLING** — Exemption from corporate income tax granted to an entity possessing a certain participation in another entity with respect to (i) income derived from such participation (e.g., dividends) and (ii) capital gains on the sale of the participation. (Holland.)

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

**DEFAULT** — Tax in "default" is tax which either has not yet been paid or, sometimes, tax which is irrecoverable.

**DEFENCE TAX** — The word "defence" is sometimes used evocatively in connection with taxation, or Government Loan issues, especially if the money is to be used for war, or for increasing armaments in times of political or military uncertainty. It may be that the word will evoke feelings of patriotism and make the public less critical of the levies than would otherwise be the case. In Switzerland, the defence tax is a levy on the profits of corporations, introduced in 1940, but still going strong.

**DEFERMENT OF TAX** — Deferment of tax payment is normally permitted in the case of foreign income which cannot be remitted to the taxpayer because of exchange restrictions in the country of origin of the income. (See UNREMITTABLE OVERSEAS INCOME.) Where FREE DEPRECIATION (q.v.) is available, the taxpayer may be able to defer tax by an exceptional reduction of taxable income, using the maximum depreciation allowances. Tax on foreign profits may also be deferred by interposing other, holding or conduit, companies between the profit-producing company and its proprietors, either for good commercial or for tax avoidance reasons. The advantages of deferment are the benefit to cash flow (and saving of interest charges) and the fact that inflation may reduce the real cost of paying the deferred tax by the time it does come to be paid.

**DEFERRED ANNUITY** — A taxpayer may pay premiums to an assurance company under a policy or contract which will secure an annuity payable to him at a later date when predictable "deferred" expenses (such as school fees for his children) may arise. Under some tax regimes tax relief may be given for the premiums when payable — there may be a stipulation that the benefits will be payable in the event of the premature death of the policy-holder. On the other hand the annuity when it arises (or the non-capital-return portion of it) will normally be taxable upon the policy-holder.

**DEFERRED REPAIRS** — During the currency of Excess Profits Duty and Excess Profits Tax in Britain as wartime levies on "excess" profits (during World War I and World War II respectively), allowances were granted in respect of the estimated cost of repairs which had to be deferred because of wartime restrictions and shortages. Had normal repair work been carried out year by year the cost would have been debited to profits and accordingly the wartime profits being taxed were artificially high, and it would have been anomalous to tax those profits without regard to the back-log of repairs which would have had to be carried out after the war.

**DELAYED REMITTANCE** — See UNREMITTABLE FOREIGN INCOME.

**DELINQUENCY** — In North American parlance, tax which is in default (i.e., not yet paid) is often referred to as "delinquent" tax and the taxpayer concerned as a "delinquent" taxpayer, but there is normally no connotation of tax EVASION (q.v.) or usually of any crime other than simple non-payment.

**DEMURRAGE** — Where plant or vehicles have been hired for a certain period but have not been returned to the hirer promptly at the end of the hire period, it is common for extra amounts to be charged for demurrage or delay relating to the additional period for which the hirer has been deprived of his assets. Demurrage payments are usually taxable in the same way as the initial hire charges for the assets.

**DEPARTMENTAL ERROR** — See REMISSION ON REVENUE ERROR.

**DEPLETION ALLOWANCE** — This term has two different connotations. In Britain the term means tax relief in respect of actual depletion of minerals calculated by reference to the cost or value of the deposits and their rate of exhaustion. In the U.S., and in some countries which have adopted that part of the U.S. income tax system, allowances are given to mineral producers as a fixed percentage of the gross income excluding any deduction for rent or royalty and without relation to the actual depreciation of the mineral resources being exploited. The allowance is restricted to a ceiling of 50 percent of the taxable income from the minerals and in a sense the relief operates as an abatement of the rate of tax chargeable on the profits of various extraction industries. The percentage deduction varies according to the type of mineral being worked.

**DEPRECIATION, ALLOWANCES FOR** — Where the assets used in a business are of a type which depreciate with use it is usual for a tax allowance to be given, based on a percentage of the cost of providing the asset. (See also CAPITAL ALLOWANCES.) Although land may be a business asset, it is unusual for depreciation allowances to be given because land does not "depreciate" by wear and tear. Where, however, the land contains minerals and its value, therefore, decreases as the minerals are extracted, DEPLETION ALLOWANCE (q.v.) may be granted.

**DEPRECIATION AT CHOICE** — See FREE DEPRECIATION.

**DEPRECIATION, FREE** — "Free depreciation" is the term applied where the taxpayer is allowed to determine the rate of depreciation (up to 100 percent) which may be allowed to him as a deduction in computing his income tax profits. The system is convenient in that it may be used by the taxpayer to avoid adjustments between the profits calculated in his business accounts and those calculated for income tax purposes if he decides to claim for income tax the same level of depreciation as he adopts in his accounts. Where the taxpayer makes maximum use of free depreciation by deducting 100 percent depreciation in the year in which he buys new qualifying assets, he will come near to obtaining the fullest possible tax relief for his expenditure, the "discounting" which occurs where depreciation allowances are instead spread over a period of years, such as the lifetime of the asset, being avoided.

**DESINVESTERINGS BIJTELLING** — Disinvestment Charge (Holland).

**DESTINATION PRINCIPLE** — The principle that V.A.T. on goods should be paid in the consuming country and not in the exporting country is known as the "destination principle" and is widely adopted in existing V.A.T. schemes. The principle involves crediting the exporter with, or re-paying him, the tax on his exports when the goods are dispatched from one country to be consumed in another. The full tax will be chargeable in the receiving or "destination" country in accordance with its own V.A.T. legislation.

**DETERRENT TAXES** — This term is usually applied to penalties for late declaration or payment of tax, or for tax fraud, expressed in the form of additional tax, and intended to deter taxpayers from such offences. Occasionally, however, import duties or sales taxes may be raised to exceptional levels in order to discouage imports or consumption of certain goods, rather than to raise a revenue from the duties imposed, and such levies may be termed "deterrent" taxation.

**DEVALUATION ADJUSTMENTS** — In order to take some account of the devaluation of a currency, by inflation, especially where this has been proceeding at higher than normal rates, a country may allow assets to be revalued for depreciation purposes so that the annual allowance for income tax will relate more closely to the replacement value of the asset concerned than to the historic value as recorded in the books of the taxpayer, which may be unrealistic because of inflation.

Another example is the allowance given, e.g., in Denmark, in connection with capital gains tax, to adjust the cost of an asset by a factor representing currency inflation when computing the capital gain for tax purposes. (See also MONETARY CORRECTION.)

**DEVELOPMENT CHARGES** — The charges levied upon development values in connection with the two instances of betterment tax introduced in Britain since World War II. In the first example, introduced in 1947, a charge of 100 percent was made on the development value attributable to the granting of planning permission. This levy was repealed in 1952, having produced a net yield of £17,000,000 in the period 1948-1952, and in the subsequent exercise (1966 to 1970) the rate of tax was initially 40 percent with a forecast of increases to 45 percent and then to 50 percent.

Currently, development gains are subject to DEVELOPMENT LAND TAX (q.v.) introduced in 1974. (See also BETTERMENT TAX.)

**DEVELOPMENT GAINS** — Development is defined as the making of any change in the state, nature, or use, of land (and thus making a profit on disposal) for the purposes of the DEVELOPMENT LAND TAX (q.v.) in Britain.

**DEVELOPMENT LAND TAX** — A tax in Britain, which succeeded the development gains tax, and is noteworthy for the high rate of tax (80 percent) charged on DEVELOPMENT GAINS (q.v.), on such gains which have been removed from the charge to ordinary income tax and capital gains tax. The tax is also innovatory in including a charge (on "First letting") where the developed land is not disposed of but let.

**DEVELOPMENT OF OVERSEAS MARKETS** — Expenditure upon opening up new markets for a firm's products is normally regarded as "capital" for tax and accounting purposes, but some tax codes give some form of relief. Japan, for example, allows relief for the expenditure, and other regimes give reliefs, e.g., for extra advertising costs, or rebates related to improved export performance. On the whole such reliefs are against the spirit of G.A.T.T., but special dispensations are often made in the case of developing countries.

**DIFFERENTIAL RATES** — See GRADUATION.

**DILAPIDATIONS** — The term used to refer to accumulated repairs to premises which have been leased, and which have to be left in the original condition at the end of the term of the lease. Where such premises are vacated part way through the term, on reassignment of the lease, or at the end of the term, with a back-log of repair-work to be done, it is usual to assess the cost and collect this money from the out-going lessee. It is also usual to allow a tax deduction for the amount paid in respect of dilapidations. (See also DEFERRED REPAIRS.)

**DILLON ROUND** — The fifth round of multilateral trade negotiations held over the period 1947-1962 with a view to realising one of the main objectives of G.A.T.T. (q.v.), i.e., to reduce and stabilise tariffs on a reciprocal basis, was known as the Dillon Round (1960-1962).

**DIMINISHING RETURNS** — When the rate of indirect tax on certain commodities is raised beyond a certain point, the actual tax yield may decrease, and the point of diminishing returns is said to have been reached. The reason is that although the tax on each article purchased has been increased the total consumption of the particular commodity decreases (because of elasticity of demand) to an extent which reduces the total base more than proportionately to the increase in the rate of tax. Where the tax levy is intended to be a source of revenue it is obviously inapt to increase the rate of tax beyond the point of diminishing returns (i.e., diminishing tax yield). Where, on the other hand, the tax is deliberately pitched at a high rate to discourage consumption the taxing authority is clearly prepared for a diminishing revenue yield.

**DIPLOMA TAX** — See ACADEMIC TAX.

**DIPLOMATIC IMMUNITY** — Persons entitled to diplomatic status, heads of diplomatic missions and designated members of their staffs are exempt from income tax and other levies on income in respect of their official emoluments, and their embassies and consulates: the official residences of diplomats are also exempt from property taxes. The exemption does not apply to private incomes of such persons, nor are they exempt in their own countries, where they pay income tax in the same manner as ordinary civil servants.

**DIRECT TAXATION** — The terms applied to forms of taxation which are intended to be borne by the payer as well as, in general, being actually paid by him. Examples are taxes on the wealth and income of persons which cannot in general be passed on specifically to others to pay. (Taxes on commodities, in contrast, are usually paid initially by traders who are, however, permitted to pass the tax on to the consumer in the price charged and hence rank as indirect taxation.)

Where income tax is deducted at the source of income by the person responsible for paying the income to the taxpayer, the tax is nevertheless regarded as a direct tax upon the owner of the income, who receives a credit for the tax thus deducted when the final liability on his aggregate income is computed.

**DISABILITY PENSIONS** — Pensions paid in respect of physical disabilities, often those incurred during wartime, are usually exempted from income tax.

**D.I.S.C.** — See DOMESTIC INTERNATIONAL TRADE CORPORATION.

**DISCRETIONARY TRUST** — A trust, the trustees of which have discretion to distribute the trust income to specified classes of beneficiaries, but usually heed the wishes of the settlor, who, though not normally entitled to benefit from the trust himself, has generally ensured that the persons he wants to benefit are included in the qualifying categories. The device was much used for tax avoidance in Britain but the undistributed income of such trusts has, since 1973, been subject to an additional 15 percent investment income surcharge. Setting up such a trust may also involve the settlor in CAPITAL TRANSFER TAX (q.v.) liability. (See also SPRINKLER TRUST.)

**DISCRIMINATORY TAXATION** — In general, income taxation sets out to be neutral between different types of income on the basis that an individual has much the same taxable capacity whatever the *source* of his income. Exceptions to the rule include a discrimination or differentiation between earned or investment income. (See EARNED INCOME.) In addition, there is sometimes discrimination for or against particular types of income on the basis that they are easier or more difficult to achieve. For example, in certain countries gold and diamond mining are taxed more heavily than other industries (though South Africa gives special consideration to marginal mines). The oil industry often attracts heavy taxation, usually incorporated in special laws or in agreements with the oil companies, and in Britain property development profits currently are taxed at 80 percent compared with a normal company tax rate of 52 percent. (See also PORNOGRAPHY TAX, RESOURCE RENT TAX, DEVELOPMENT LAND TAX.)

**DIS-INCENTIVE TAX** — See DETERRENT TAXES.

**DISPOSALS** — In capital gains tax codes, liability usually arises not merely on the sale of an asset at a surplus above the cost price, but also on the donation of the asset to another person, or its transfer at less than full market value, where such value exceeds cost. The term used to cover all methods is "disposal" (in the U.S.A. "disposition" is sometimes used).
In order to reduce administrative time, relief is sometimes given by exempting small transactions, not where the gain is small but where the proceeds of disposal are small, e.g., in Britain for disposals within one year not exceeding £1,000.

**DISPOSITIONS** — See DISPOSALS regarding capital gains tax. The term is also used in respect of the use to which a taxpayer may put parts of his income or capital, usually in transactions designed to reduce his tax bill.

**DISTRAINT** — A method (also known as DISTRESS) used for the recovery of taxes (but also of other debts) which consist of the legal seizure of the assets of a taxpayer which may be sold for recovery of unpaid taxes.

**DISTRESS** — See DISTRAINT.

**DISTRIBUTED PROFITS TAX** — A tax on dividends and other distributions of corporate profits, sometimes on the basis that additional tax is charged where the distributions exceed certain set limits. In Britain discriminatory tax rates were charged on all distributed profits as a feature of PROFITS TAX (q.v.) for the period April 1947 to April 1958 as a means of discouraging distributions in order to curb inflation. The maximum degree of discrimination was in the period 1955/1956 when undistributed profits were taxed at 2½ percent and distributed profits at 27½ percent, a ratio of 1 : 11 — both types of profits being also subject to income tax at 42½ percent.

**DISTRIBUTIONS** — The term refers mainly to dividends paid by companies to their shareholders and to sums of capital and income paid out to beneficiaries of trusts and estates of decreased persons by trustees, executors and administrators. Where tax avoidance is attempted in the case of CLOSE COMPANIES (q.v.) through over-restriction of dividends and the directors/shareholders are enabled to withdraw money invested by other devices such as loan accounts or overpayment for their services, property, etc., such outgoings may be statutorily deemed to be "distributions" for tax purposes. In addition, distributions may be deemed to have been made, even where there has been no outgoing of any form, in order to equate the tax position of companies which have underdistributed with those that have met the statutory requirements.

**DIVIDENDBELASTING** — Withholding tax on dividends and interest paid on profit-sharing bonds (Holland).

**DIVIDEND CONTROL** — A device used for anti-inflationary purposes, partly for its own sake but usually as part of a package which includes wage restraint, rent control, and price control. It is felt that dividends must be restricted so as to appease the workers. In the short term there is no great economic harm, but if dividend restrictions continue too long, there is distortion (or abortion) of investment and the "control" becomes a tax upon shareholders who are discriminated against compared with other investors. (See also QUASI-TAXATION.)

**DIVIDEND STRIPPING** — A tax avoidance device whereby a company which had reserves of accumulated taxed profits was purchased and the profits fully distributed as dividends in respect of which tax relief would be due while the company could thereafter be resold at a loss deductible in arriving at the profit of the financial concern carrying out the transactions.

**DIVIDEND WITHHOLDING TAX** — See WITHHOLDING TAX.

**DIVIDENDS IN KIND** — Dividends are normally paid in cash, but sometimes, in the course of company reconstruction, a new company may be set up out of existing resources and its shares distributed to shareholders of the main company pro rata to their main shareholdings. Sometimes bonus issues of loan stock or debentures are made, or of additional shares in the company when its capital has increased since the original share issue. Where the shareholder's position is the same as regards the stake he holds in the company after the transactions there is usually no tax liability on the distribution in kind, but the subject is complex and some countries have special laws to tax distributions which can be turned into cash without the shareholder losing or reducing his stake in the company's equity capital.

**DIVORCE** — The tax consequences o divorce may be that (as in the cas of the death of her husband) th divorced wife may be entitled to ne personal reliefs as a single woman fo the part of the tax year after divorc (See also ALIMONY.)

**DOCHTERMAATSCHAPPIJ** — Subsidiar company (Holland).

**DOCUMENT TAX** — A tax on the use o certain documents, usually in the forn of a stamp duty, stamps having i some instances to be fixed to or im pressed on the document. The tax is in effect, one upon the form rathe than the substance of a transactio and is generally an undesirable form o tax since it may be avoided by makin the same transaction in different way with, however, some possible com mercial inconvenience.

**DOLLAR PREMIUM** — A levy on invest ments outside the "sterling area" b residents of certain parts of the area notably Britain. Strictly, the levy is a "investment premium" which applie to all investments outside the area, no merely those in dollar countries. Fo British residents the process of dis investment in premium countries in volves a "surrender" of 25 percent o the foreign currency proceeds to b sold at current market rates, while th remaining 75 percent may be sold i the premium market. The forfeiting o 25 percent of the premium con stitutes a form of capital tax o foreign investment. As for the pre mium itself, the investor may gain o lose, respectively, if the premium is a a higher or lower level (the level de pending on the supply/demand situa tion for non-sterling investments at th time) when the investment is sol compared with the premium prevailin at the time of purchase.

**DOMESDAY BOOK** — An inventory o real property in England for the pur pose of taxing the owners thereof compiled in 1086 during the reign o William I. The data thus compile were also subsequently used in th levying of DANEGELD (q.v.) and lan and property taxes generally.

**DOMESTIC CORPORATION** — In U.S tax parlance, a domestic corporatio is one which was organised or create in the U.S. or under the laws of th U.S. or of any State. Note that th term "Corporation" includes associa tions, joint-stock companies and insur ance companies.

**DOMESTIC INTERNATIONAL SALES CORPORATION (D.I.S.C.)** — For U.S corporation tax purposes, a separate subsidiary corporation may be set up to deal with export trade. The cor poration may have a FOREIGN INTERNATIONAL SALES CORPORATION (F.I.S.C.) as a subsidiary, and is entitled to a large degree of deferment of payment of corporation tax on the profits of its foreign trade. The object of the D.I.S.C. provisions is to give an incentive to export trade.

**DOMESTIC MARKET PRICE** — Some countries levy customs duty not on landed price (including carriage, insurance and freight) but on the selling price of the goods in the country of origin, sometimes referred to as "domestic market price". The system (also sometimes loosely known as the F.O.B. value system) is gradually being superseded by the C.I.F. method of valuation adopted in the Brussels Agreement. (See BRUSSELS DEFINITION OF VALUE.)

**DOMESTIC TAX EQUALITY** — This is the principle that all taxpayers living in a country should be treated alike for tax purposes, particularly income tax, e.g., they should be taxed on their world income so that those residents with small local incomes but with investments overseas will be in the same position as those with a similar total income derived wholly from local sources.

**DOMICILE TAX** — "Domicile" is a difficult legal concept, although in most cases a taxpayer may be regarded as domiciled in the country where he was born ("domicile of origin") until he takes up permanent residence in another country where he expects to spend the rest of his life, when the latter country will normally become his "domicile of choice, or adoption". For certain purposes, particularly the imposition of death duties, the taxpayer's domicile may be significant. It is common, for example, for a country to tax all the assets passing on death (except foreign immovables) where the taxpayer is domiciled in the taxing country, whereas for income tax the concept usually used is that of "residence" and sometimes "ordinary residence". (There are some exceptions where domicile is also used as a factor in determining income tax liability and the U.S. uses citizenship as a criterion for certain tax purposes.) Where the assets of a deceased person are situated in a country in which he is not domiciled the country restricts its death duties to the assets actually in the country. One or two countries (notably the U.K.) now extend death duties to the world assets, including foreign immovables, where the taxpayer is domiciled in the taxing country although, of course, it is usual to give double taxation relief for foreign tax on foreign assets.

**DOMICILIARY COMPANY** — A company which has its seat in Liechtenstein but carries out its activities abroad may be registered as a domiciliary company or "Sitzunternehmen", is exempt from income tax and pays net worth tax only at the 0.1 percent rate. Such a company must have a Liechtenstein resident to represent it. There are broadly similar provisions in Switzerland, where a domiciliary company is exempt from cantonal tax in most cantons but not from federal tax nor from the net worth tax. These companies are widely used in connection with tax avoidance schemes.

**DONATION, DROIT DE** — Gift tax (Belgium, France).

**DONATION DUTY** — Another term for gift tax.

**DONATIONS, COVENANTED** — See COVENANTS.

**DOPPELBESTEUERUNGSABKOMMEN (DBA)** — Double taxation treaty (Germany.)

**DOUBLE ALLOWANCE** — A double allowance for income tax purposes may sometimes arise, for example, where an individual is entitled to child allowance for a daughter up to the age of marriage while her husband is entitled to wife relief for the remainder of the tax year. Similarly, in the case of a death, or divorce and remarriage within the same year, more than one person may be able to claim for another person as a dependent. Some countries allow the full relief to be granted to each legitimate claimant but in other cases the allowance may be divided between those who can claim during the same tax year.

**DOUBLE TAXATION** — Where income is chargeable in the source country and also in the country of residence of the owner of the income, there is said to be double taxation of that income. It is increasingly common to try to avoid or abate double taxation by a double taxation agreement, convention or treaty usually made bilaterally between two countries. In general, the country of source is given first right to tax the income, the country of residence giving either exemption or tax relief for the other country's tax, but for limited categories of income, e.g., commercial pensions, and sometimes dividends, royalties and interest, there may be mutual agreement that the country of residence shall have sole taxing rights. (See also WITHHOLDING TAX.)
The term may also be used to refer to the position where corporate income is subject to corporation tax or company income tax and is taxed again by way of personal income taxation on the shareholders when the income is distributed as dividends. (See ECONOMIC DOUBLE TAXATION and DUAL TAX.)
When there is a change in the system of sales taxation in a country, such, for example, that a manufacturer's or wholesaler's tax is replaced by a retail sales tax or a V.A.T., goods which have already paid sales tax at the time of the change may be subjected to further tax under the new system. Transitional arrangements are usually made to avoid or relieve such double taxation. (See TRANSITION ADJUSTMENTS.)

**DRAWBACK** — The term "drawback" is used to refer to refunds of customs duty, usually on the re-export of the goods subjected to the duty, but occasionally when the goods are used for some purpose within the country to produce a product which is exempted from taxation. The term also applies to refunds of duty on imported components which are incorporated in exported manufactured goods, and, in Canada, to refunds of Federal sales tax (MANUFACTURERS' TAX q.v.) on components that are manufactured in Canada.

**DROIT** — (a) A tax, as in DROIT D'APPORT (Holding Company Tax, Luxembourg), DROIT DE DONATION, DROITS D'ENREGISTREMENT (registration taxes (in Luxembourg) encompassing inter alia the droits d'apport, de succession, and de donation), DROIT DE SUCCESSION (succession duty), DROIT DE TIMBRE (stamp duty, Switzerland).
(b) A right, or privilege, as in DROIT DE PREEMPTION (q.v.) and droit de seigneur.

**DUAL TAX** — A term sometimes used to refer to the taxing of both corporate income and the dividends paid out of such income, leaving the term "double taxation" to refer only to cases of the taxation of the same income in two different countries.

**DUMPING** — The sale of goods produced in one country at a price in another which is less than the domestic price in the exporting country. The term is defined in the Agreement on Implementation of Article VI of G.A.T.T., Part 1, Article 2(a) as the introduction of a product "into the commerce of another country at less than its normal value, if the export price of the product exported from one country to another is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country". "Dumping" is notoriously difficult to establish because of the range of prices of the same goods which may apply in different circumstances, e.g., within the same country sale prices may be lower in supermarkets and chain stores than in other retail outlets. Moreover, one country's prices may be affected by elements of TAXE OCCULTE, etc.

[ to be continued ]

# E.E.C.:

## Mutual Assistance between Revenue Departments*

On 21 November the Council recorded its agreement in principle on a directive laying down arrangements for close collaboration between the Member States' revenue departments in the field of direct taxation, with a view to strengthening the drive to combat international tax evasion and avoidance.

This directive constitutes the legal implementation of the resolution of 10 February 1975, [1] in which the Council recognized that these problems have an international dimension and must be combated energetically at international level. The directive — which is the first Community instrument to be adopted so far in the field of direct taxation — represents a major initial step in this direction.

The main purpose of the directive is to enlarge the procedure of systematic exchange of information to cover all information that may assist in determining the correct liability to taxes on income and on capital. Its scope therefore goes beyond the existing bilateral assistance between Member States, extending it to the whole of the Community.

The exchange of information may take place at the request of the Member State concerned, but there may also be transmission of unsolicited information where a State, having no evidence, has no cause to take the initiative. Such exchanges without request may be automatic — for certain categories of cases which have still to be determined — by common agreement between the two revenue departments concerned, or spontaneous, where a revenue department feels that certain situations may be of interest to another Community revenue department. Spontaneous exchange will take place, for example, where there are grounds for supposing that tax is being avoided by the device of transfer pricing between firms belonging to the same group.

The information exchange arrangements are supplemented by a rule under which one Member State may make inquiries on behalf of another Member State. The directive also provides that the presence of officials of one Member State may be authorized on the territory of another Member State, with a view to clarifying a given situation, but this provision is purely optional and requires agreement between the revenue departments concerned before it can be applied.

With a view to proper protection of the rights and interests of taxpayers, the directive provides for very strict common rules of secrecy, ensuring that the information will not be improperly disclosed or used for purposes other than taxation.

Finally, the directive provides for permanent cooperation arrangements between the Member States and the Commission, firstly with a view to improving mutual assistance arrangements and where necessary to broadening the scope of the collaboration already agreed, and secondly with a view to drawing up, in the light of the experience pooled by all revenue departments, such Community rules as may be needed to prevent transfer pricing.

The directive will be formally adopted by the Council at one of its forthcoming meetings, once the text in the various languages has been finalized.

* Bulletin of the European Communities 11/1977 at 33.

1. OJ C 35 of 14.2.1975.

**The full text of this Directive will be reproduced in the February 1978 issue of the Supplementary Service to European Taxation, published by the International Bureau of Fiscal Documentation, Amsterdam.**

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# Contents

of the February 1978 issue



**In the next issues:**

France: The new withholding tax on wages paid to non-domiciliaries and taxation of wage payment for foreign activities
— by *Patrick Michaud and Michel Saillant*

The German Corporation Tax Reform and the revision of its double tax treaties
— by *Dr. Theodor Faist*

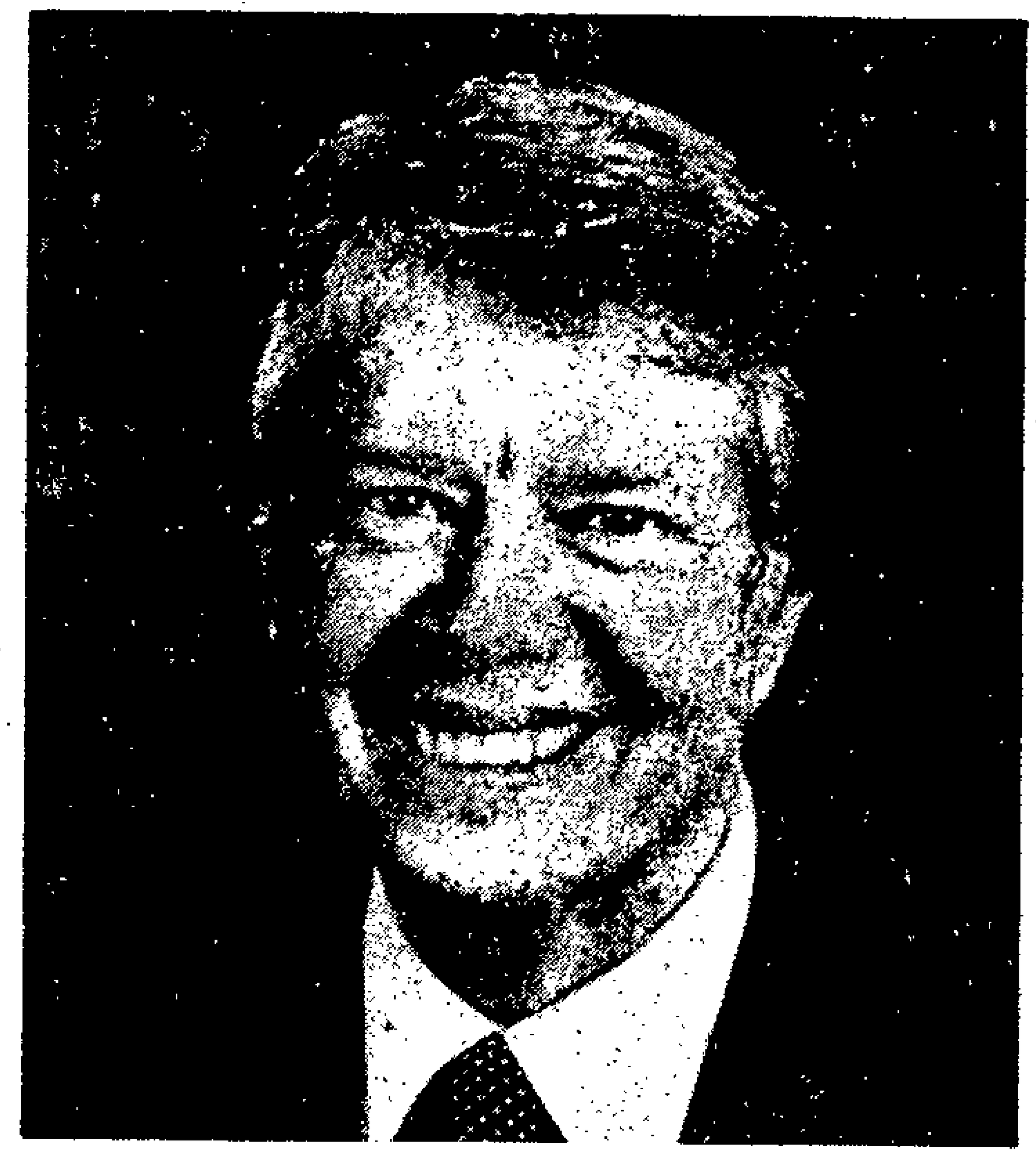
Large scale tax increase in Japan, the recommendation of the Tax Commission
— by *Makoto Miura*

Fiscal incentives for Japan's exports and direct foreign investment
— by *Tomotaka Ishimine*

# UNITED STATES:

# President Carter's 1978 Tax Message

*On January 21, 1978 President Carter sent his Tax Message to Congress recommending the reform of the U.S. tax system and thus providing $25,000 million in net tax reductions for individuals and businesses. The president stresses the need for both* tax reduction *as well as* tax reform.



### A. Tax Reduction

*The tax reduction consists of:*

*(i) $17,000 million in net income tax cuts for individuals, through across-the-board rate reductions and a new personal credit, focused primarily of low and middle-income taxpayers;*

*(ii) $6,000 million in net income tax cuts for small and large corporations, through reductions in the corporate tax rates and extensions of the investment tax credit;*

*(iii) $2,000 million for elimination of excise tax on telephone calls and a reduction in the payroll tax for unemployment insurance.*

### B. Tax Reform

*The $25,000 million tax reductions are net reductions,* after *taking into account of $9,000 million in revenue-raising reforms which are proposed. Guided by the need for tax reform the President requests Congress to adopt reforms which would:*

*1 Sharply curtail tax shelters.*

*2 Eliminate the deductions claimed by businesses for theater and sporting tickets, yachts, hunting lodges, club dues, and first-class airfare and limit the deduction for the cost of meals to 50 percent.*

*3 Provide a taxable bond option for local governments and modify the tax treatment of industrial development bonds.*

*4 Strengthen the minimum tax on items of preference income for individuals.*

*5 Repeal the special alternative tax on capital gains, which only benefits individuals in the highest tax brackets.*

*6 Replace the personal exemption and general tax credits with a $240 per person credit.*

*7 Simplify return preparation and recordkeeping by:*

*(i) eliminating the deductions for sales, personal property, gasoline, and miscellaneous taxes;*

*(ii) combining the separate medical and casualty deductions and allowing them only to the extent they exceed 10 percent of adjusted gross income;*

*(iii) repealing the deduction for political contributions but retaining the credit; and*

*(iv) liberalizing and modifying the Subchapter S and depreciation rules applicable to small businesses.*

*8 Include unemployment compensation benefits in the taxable income of taxpayers above certain income levels.*

*9 Ensure that the tax preferences available for fringe benefits assist rank-and-file workers as well as executive officers.*

*10 Eliminate the special bad debt deduction for commercial banks, reduce the bad debt deduction available to savings and loan associations, and remove the tax exemption for credit unions.*

*11 Phase out the tax subsidies for Domestic International Sales Corporations (DISCs) and the deferral of tax on foreign profits.*

**TABLE OF CONTENTS**

# An Overview of President Carter's Tax Recommendations*

**A. For corporations:**

— the reduction of the corporate income tax rates on 1 October 1978: 18 percent on the first $25,000 of profit (currently 20 percent); 20 percent on the next $25,000 (currently 22 percent) and 45 percent on profits exceeding $50,000 (currently 48 percent). A further reduction would apply on 1 January 1980 from 45 to 44 percent;

— the elimination of the benefits granted to Domestic International Sales Corporations (DISC): one third of DISC benefits in 1979, two thirds in 1980 and all DISC benefits after 1980;

— the profits made by foreign subsidiaries of U.S. corporations should be subject to U.S. tax, even if not distributed. It is suggested that at least one third of the foreign subsidiary's profits will be taxed to the U.S. parent in 1979, at least two thirds in 1980 and the entire profits in 1981 (of course any foreign tax on these profits may be credited against U.S. tax).

**B. Business in general**

— the 10 percent investment credit would be made permanent. The ceiling would be increased to 90 percent of tax liability (presently $25,000 plus 50 percent of tax liability) and the investment credit would also apply to industrial structures;

— less favorable bad debt deductions for commercial banks and mutual savings banks and savings and loan associations are proposed. Credit unions are at present tax exempt, but they would be taxed as mutual savings banks after 1982;

— limited partnerships with more than 15 limited partners should be treated as corporations (with an exemption for partnerships engaged primarily in housing activities);

— a partnership should be treated as an entity for the purpose of determining tax issues, instead of the present system under which each partner must be audited separately;

— with a few exemptions real estate should be depreciated on the straight-line method;

— reduction of the Federal unemployment tax on employers from 0.7 to 0.5 percent of wages paid;

— no deduction for certain business-related entertainment costs; such as tickets for theater and sporting events and other entertainment expenses for maintaining facilities such as yachts, hunting lodges, swimming pools, fees paid to clubs; 50 percent of business meals would be deductible only;

— no deduction for costs to attend foreign conventions, unless it can be proven that it is reasonable to hold such a convention outside the U.S.A.;

— no deduction for fist class air fare tickets for domestic business travel (this rule already applies to flights to foreign conventions).

**C. Individuals**

— the introduction of a new individual income tax table, ranging from 12 to 68 percent (now from 14 to 70 percent), (favoring low income groups;

— the introduction of a single $240 personal credit to replace the existing personal exemption and alternative general credits, as of 1 October 1978;

— the introduction of changes in itemized deductions, so that 84 percent of the taxpayers, against 77 percent at present, would use the standard deduction.
This might be done by abolition of deduction for general sales taxes, taxes on personal property, gasoline taxes and miscellaneous local taxes; by abolition of the deduction for political contributions (but maintaining the credit against tax for 50 percent of such contributions with a maximum credit of $50 on a joint return); and by introducing a more simple system of medical and casualty deductions;

— the minimum tax should be applied to tax preference items in excess of $10,000. The other limitation, half the regular tax paid, should be abolished. This minimum tax would not apply to gains on the sale of a personal residence;

— the abolition of the 25 percent alternative tax on the first $50,000 of capital gains;

— the denial of tax exemption for employer-established medical, disability and group life insurance plans, if these plans discriminate in favor of officers, shareholders and higher-paid employees;

— the abolition of the exclusion from tax of the first $5,000 of payments made by the employer on account of the death of an employee;

— qualified pension plans may not provide benefits to supplements social security for highly compensated employees unless all employees (including those whose wages do not exceed the social security wage base) receive some coverage under the plan;

— the current tax exemption for unemployment compensation benefits should be phased out if income arises above $20,000 for single persons and $25,000 for married couples;

— earnings on deferred annuities should be taxed currently to the taxpayer. Exemptions would be granted if the annual premium does not exceed $1,000 and in case of qualified employee annuities;

— the rule that denies deductibility for a shelter investor's paper losses that exceed cash investment and indebtedness for which he personal liability should be extended to cover all activities (except real estate) carried on individually, through partnerships or by corporations controlled by not more than five persons.

**D. Miscellaneous:**

— state and local governments may continue to issue tax-exempt bonds, but if they issue fully taxable bonds, they will receive a subsidy equal to 35 or 40 percent of interest paid. The same possibility would be created for industrial development bonds.
Tax free bonds for financing industrial parks, pollution works, or private hospitals would, in general, be abolished;

— abolition of the 4 percent excise tax on telephone services on 1 October 1978.

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* This overview was reprinted from the February 28, 1978 issue of TAX NEWS SERVICE, an other publication of the INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION.

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President Carter:

We must also act to ease the burdens of tax return preparation and record-keeping. We have a tax system that requires millions of individuals to compute their own tax liability. The government relies upon the good faith and conscientiousness of our taxpayers to an extent unparalleled in the rest of the world. But in order for our system to remain successful, it must be comprehensible to the average taxpayer.

Judged by this standard, the current tax structure is seriously defective. Millions of honest and intelligent Americans find themselves confused and frustrated by its complexity. The cost of this complexity is enormous in terms of hours and dollars spent.

The following are excerpts from the President's Tax Message which are of prime importance to the international business community.

## I. TOWARDS A FAIRER TAX SYSTEM

### A. Entertainment and Other Expenditures for Personal Consumption

One feature of the current tax system that is most disheartening to average taxpayers is the favorable tax treatment accorded extravagant entertainment expenses that are claimed to be business-related. Some individuals are able to deduct expenditures that provide personal enjoyment with little or no business benefit. And, even where entertainment expenditures may have some relationship to the production of income, they provide untaxed personal benefits to the participants. More than $2 billion of tax revenue is lost every year through these tax preferences.

For example, one person claimed a deduction of $17,000 for the cost of entertaining other members of his profession at his home, at a country club, at sporting events, at restaurants, and at a rental cottage. Another individual wrote off the cost of business lunches 338 days of the year at an average cost far exceeding $20 for each lunch. But there is no deduction in the tax laws for the factory worker's ticket to a football game or the secretary's lunch with fellow workers.

These special tax advantages for the privileged few undermine confidence in our Nation's tax system. The disparity must be eliminated by denying a deduction for expenditures to the extent they provide the participants with such untaxed personal enjoyment and benefits.

(1) *Theater and Sporting Events.* No deduction will be permitted for purchases of tickets to theater and sporting events. Present law, by allowing a deduction for the purchase of such tickets, provides a "two for the price of one" bargain to some taxpayers. As long as an individual is in the 50 percent tax bracket or above, he may be able to invite a business friend at no cost to himself by having the Federal government pay for at least one-half of the total ticket costs. The overwhelming majority of our citizens pay for their theater and sports tickets out of their own after-tax dollars. No taxpayer should be asked to help subsidize someone else's personal entertainment.

(2) *Other Entertainment Expenses.* The tax reform program will also deny deductibility of any expenses of maintaining facilities such as yachts, hunting lodges and swimming pools and for fees paid to social, athletic, or sporting clubs. During a recent tax year, one small corporation deducted $67,000 for yacht expenses incurred in entertaining customers and potential customers on cruises and fishing trips. Another small company deducts over $100,000 a year to maintain hunting and fishing lodges to entertain employees of customers. Asking taxpayers to subsidize these kinds of activities for a tiny minority of our citizens strikes at the fairness and integrity of the tax system.

(3) *Business Meals.* Fifty percent of currently deductible business entertainment expenses for food and beverages will remain deductible, and 50 percent will be disallowed. A substantial portion of business meal expenses represents the cost of personal consumption that must be incurred regardless of the business connection. The million of Americans who work on farms, in factories and in offices should not be required to provide their tax dollars to support the high-priced lunches and dinners of a relatively small number of taxpayers. The 50 percent disallowance represents a reasonable and fair approach to compensate for the untaxed personal benefit involved.

**Income Tax and Social Security Tax Burden Table**
**Married Couple with Two Children**
**(1976 Levels of Income)**

| Expanded income class ($000) | Income Tax | | | Social Security tax increase | Average net tax change |
|---|---|---|---|---|---|
| | Average tax present law | Average tax under proposal | Average tax change | | |
| Less than 10 | .9 | -79 | -88 | 16 | -72 |
| 10-15 | 867 | 589 | -278 | 30 | -248 |
| 15-20 | 1,739 | 1,461 | -278 | 48 | -230 |
| 20-30 | 3,117 | 2,780 | -337 | 115 | -222 |
| 30-50 | 6,287 | 5,979 | -308 | 192 | -116 |
| 50-100 | 16,336 | 16,088 | -248 | 232 | -16 |
| 100-200 | 40,885 | 41,087 | 202 | 268 | 470 |
| 200 and over | 127,666 | 130,473 | 2,807 | 145 | 2,952 |

(4) *Foreign Conventions.* Many professional, business, and trade organizations can furnish their members with tax-deductible foreign vacations. The method of conferring such tax-subsidized luxury is to sponsor a foreign convention or seminar. A brochure for one professional organization provides the appropriate atmosphere in promoting its foreign seminars:

"Decide where you would like to go this year: Rome. The Alps. The Holy Land. Paris and London. The Orient. Cruise the Rhine River or the Mediterranean. Visist the islands in the Caribbean. Delight in the art treasures of Florence."

The Tax Reform Act of 1976 placed some limits on the deductibility of foreign convention expenses. But the rules still permit taxpayers to take two foreign vacations a year partially at public expense — an exception that did not escape the attention of the organization whose 1977 brochure I have quoted.

I am proposing that the deductibility rules for foreign conventions be modified in a manner that will curb abuses while relaxing the current restrictions on conventions held in foreign countries for legitimate business purposes. The two convention rule will be stricken. In its place will be a rule that denies deductibility for foreign convention expenses unless factors such as the purpose and membership of the sponsor make it as reasonable to hold the convention outside the United States and possessions as within.

(5) *First Class Air Fare.* Another example of public support for private extravagance is the deductibility of first class air fare. Business travel constitutes a legitimate cost of producing income. However, the business purpose is served by purchasing a ticket at coach fare. The undue generosity of a deduction for first class air fare was recognized by Congress in 1976 when a deduction was denied for first class flights to foreign conventions. I propose that the rule be extended to tickets for domestic business travel.

## B. Tax Shelters

Through tax shelters, persons can use "paper" losses to reduce taxes on high incomes from other sources. These shelter devices can slash the effective tax rate for many affluent individuals far below that of average income Americans. Moreover, such shelters attract investment dollars away from profit-seeking businesses and into ventures designed only for tax write-offs; legitimate businesses suffer competitive disadvantages as a result.

In the Tax Reform Act of 1976, Congress enacted reforms intended to restrict tax shelter abuses. The principal methods used in that legislation were revisions of the minimum tax and the adoption of an "at risk" rule to limit the deductibility of certain tax shelter losses.

However, some promotors have now adapted their operations to provide shelters in forms that were not specifically covered by the 1976 Act. In fact, shelter activity in 1977 may have surpassed the level reached in 1976. Form letters, addressed to "All of Us Who Wish to Reduce Our Taxes," boldly promise tax write-offs several times larger than the amount invested, and persons are urged to pass the message along "to anyone you think may have interest in tax reduction." Tax shelter experts promote their services in large and expensive advertisements in the financial sections of our Sunday papers.

Such flagrant manipulation of the tax laws should not be tolerated. I recommend action that will build upon the 1976 reforms and further reduce tax shelter abuses.

(1) *Strengthening of the Minimum Tax.* The minimum tax has proved to be one of the most useful devices to limit the attractiveness of tax shelter schemes, and it should be made still more effective. In its current form, the minimum tax is imposed at a rate of 15 percent on the amount of certain tax preference items enjoyed by a taxpayer. But the total amount of tax preferences can be reduced by the greater of $10,000 or one-half of regular tax liability (in the case of individuals) before the minimum tax is applied.

I recommend that the minimum tax for individuals be strengthened by eliminating the offset of one-half of regular tax liability against preference income. This change will make the minimum tax more progressive and a more sharply focused deterrent to the use of tax shelters. Persons making excessive use of preferences will be taxed on their preference income without regard to regular tax liability. On the other hand, those individuals with modest preference income will still be totally exempted from the minimum tax by the $10,000 preference offset, and the minimum tax will not be applied to capital gain realized on the sale of a personal residence. Ninety-eight percent of the $284 million in revenue raised by this proposal will come from taxpayers with incomes exceeding $10,000 and more than 77 percent will come from the income class over $200,000.

(2) *Extension of "at risk" Rule.* One of the 1976 reforms that should be toughened is the "at risk" rule. That rule denies deductibility for a shelter investor's paper losses that exceed his cash investment and indebtedness for which he has personal liability. My tax reform plan will generally extend the "at risk" provisions to cover all activities (except real estate) carried on individually, through partnerships, or by corporations controlled by five or fewer persons.

(3) *Changes in Real Estate Depreciation.* Reform of real estate depreciation practices is needed to reduce much of the wasteful tax shelter investment that has led to overbuilding of commercial real estate in such forms as shopping centers and office buildings. Real estate shelters were left virtually untouched by the 1976 Act. Consequently, these shelters have continued to thrive.

It is time to move depreciation for tax purposes more closely into line with a measurement of actual economic decline. The reform program will generally require taxpayers to base their depreciation for buildings on the straight-line method, using the present average tax lives claimed by taxpayers to different classes of property. Exceptions from the general rule will be granted until 1983 for new multi-family housing, which will be permitted to use a 150 percent declining balance method; new low-income housing will remain eligible for a 200 percent declining balance method until 1983, and for 150 percent thereafter. Needed investment in industrial plants will be encouraged by an extension of the investment credit, as explained below. The investment credit is a more efficient and straight-forward means to provide a tax subsidy for such construction.

(4) *Taxation of Deferred Annuities.* Another flourishing tax shelter gimmick is the deferred annuity contract. Currently, a person can generally invest in an annuity contract and postpone taxation on the interest build-up until the annuity is actually received. Although originally designed primarily to provide a safe flow of retirement income, the deferred annuity contract is now used commonly as a convenient tax dodge for a wide range of investment opportunities. The shelter benefits are aptly described by the promotional literature:

**"How to postpone taxes legally and earn interest on Uncle Sam's money. . . With An Investment That Never Goes Down, Always Goes Up, And Is Guaranteed Against Loss."**

I recommend that this tax abuse be eliminated. Under my proposal, the earnings of most deferred annuities will be taxed currently to the purchaser. However, in order that an individual may still use a deferred annuity with guaranteed interest as a means to provide retirement income, the proposal will allow each person to designate a single contract, contributions to which may not exceed $1,000 annually, as a contract that will remain eligible for tax deferral. Also unaffected will be the tax treatment of qualified employee annuities.

(5) *Classification of Nominal Partnerships as Corporations for Tax Purposes.* In many cases, tax shelter schemes can offer the desired tax benefits to investors only if the shelter vehicle is organized as a partnership rather than a corporation. At the same time, limited partnerships can now provide traditional non-tax attributes of a corporation, such as limited personal liability, centralized management, and transferability of interests without sacrificing partnership tax benefits.

Promotors should not obtain the non-tax attributes of a corporation for their shelters while using technicalities to avoid corporate tax treatment. I recommend that new limited partnerships with more than 15 limited partners be treated as corporations for tax purposes; however, partnerships engaged primarily in housing activities will be excepted from this classification rule.

(6) *Tax Audit of Partnerships.* Tax shelter partnerships are not themselves subject to the tax assessment mechanism of the Internal Revenue Service; therefore, each individual partner must be audited separately even though the same substantive determinations may be involved. I recommend that legislation be enacted to permit a partnership to be treated as an entity for the purpose of determining tax issues. Tax shelters based on illegitimate deductions should not be permitted to succeed merely because of the difficulties involved in conducting an IRS examination of their activities.

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*The President's Proposal:* The use of tax shelters to avoid or reduce income tax will be restricted by:
— extending to closely held corporations and to all activities except real estate the rule limiting losses than can be used to offset other taxable income to the amount the taxpayer actually has "at risk" in the activity;
— treating as corporations for tax purposes limited partnerships with more than 15 limited partners, other than those primarily engaged in residential real estate;
— authorizing the IRS to carry out tax audits of partnerships and to determine taxable income at the partnership level;
— limiting the amount of tax liability which can be offset by the investment credit to 90 percent of tax liability;
— imposing taxes currently on the earnings of most deferred annuities not purchased under qualified retirement plans.

*Present Law:* Taxpayers continue to invest in tax shelters through loans for which they are not personally liable and deduct paper losses which exceed any actual losses that they might incur. A taxpayer is considered to be at risk to the extent of cash and other property the taxpayer contributes to the activity and also to the extent of any borrowings with respect to which the taxpayer has personal liability.
Limited partnerships allow the partners to deduct their pro rata share of partnership losses while enjoying practically all the advantages that result from a corporate form of business organization. But under the corporate form losses normally are not passed through to the shareholders.
The IRS must determine the taxable income of each partner separately since it cannot audit at the partnership level.
The investment tax credit may offset completely the first $25,000 of tax liability.
Earnings on deferred annuities, perhaps including those that provide a considerable degree of investment control by the purchaser, are not taxed until the annuity is received.

*Reasons for the Recommendation:* These measures will make the tax system fairer by restricting the ability of high-income taxpayers to pay less income tax than others with like incomes. The spectacle of high income individuals not paying their fair share of tax seriously undermines the morale of moderate income Americans.
In the Tax Reform Act of 1976, Congress adopted a rule limiting the deductibility of certain tax shelter losses to the amount "at risk." But new types of shelters, which avoid the explicit restrictions of the 1976 Act, have been created, extensively promoted, and widely marketed. These shelters serve no public purpose. Taxpayers seeking to avoid paying their fair share of the tax burden should not benefit from large limited partnerships that have the characteristics of corporations or from the difficulties in carrying out tax examinations of tax shelter activities. Allowing the IRS to audit partnerships as a distinct economic unit would result in more efficient and effective review of questionable tax shelters.
Taxpayers should not be able to use deferred annuities to avoid current taxation of regularly recurring investment income.

*Effect on Taxpayers:* Taxpayers, chiefly with high incomes, who are able to use tax shelters to avoid or reduce their tax payments, will pay higher taxes.

*Effect on Revenue:* These proposals will increase tax liabilities $200 million in calendar year 1979, rsising to $1,000 million in 1983. [Fact Sheet # 16.]

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## C. Termination of Alternative Tax for Capital Gains

The wages of most workers are fully subject to tax at the rates contained in the published tax tables. But persons whose income arises from the sale of assets such as stock or land generally receive preferred treatment: a deduction for long-term capital gains has the effect of taxing these gains at a rate that is one-half of the rate for ordinary income. This preference results in an annual revenue loss to the Treasury of $8 billion.

Taxpayers in the highest income brackets are granted an additional tax preference over and above the special capital gains deduction. Individuals above the 50 percent tax bracket can take advantage of a 25 percent tax ceiling on the first $50,000 of capital gains, a provision known as the "alternative tax." The benefits of this provision go exclusively to persons with taxable incomes exceeding $52,000 (if filing a joint return) or $38,000 (if filing a single return) — less than one percent of all taxpayers.

Through the alternative tax, a wealthy investor can shield nearly 65 percent of his capital gains from taxation — a benefit that is grossly inequitable when middle-class investors are taxed on one-half of such gains, and most workers are taxed on every cent of their wages and salaries. The alternative tax costs the Treasury over $100 million every year, almost 90 percent of which goes to taxpayers in income classes above $100,000. I propose the repeal of this unfair and complicated tax benefit.

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*The President's Proposal:* Fifty percent of long-term capital gains will continue to be excluded from an individual taxpayer's taxable income, but the special 25 percent alternative tax on the first $50,000 of capital gains will be repealed.

*Present Law:* One-half of a long term capital gain is included in an individual's tax base (thus the effective rate of tax ranges from 7 to 35 percent). A special limit provides that $50,000 of these gains each year are not to be taxed at over 25 percent. A taxpayer in the 70 percent tax bracket with $50,000 of capital gains can use the alternative tax to reduce his or her tax on the capital gains by nearly 30 percent of the capital gains tax otherwise due.

*Reasons for the Recommendation:* The elimination of the 25 percent alternative tax on capital gains of up to $50,000 in any one year will end an unjustified benefit for taxpayers whose marginal tax rates exceed 50 percent — single taxpayers with taxable incomes of more than $38,000 and married taxpayers filing a joint return with taxable incomes over $52,000. Thus, the proposal will make the tax treatment of capital gains more equitable without disturbing the favorable treatment of capital gains in general.

The alternative tax introduces significant additional complexity into an individual's tax planning and its repeal will simplify the tax laws.

*Effect on Taxpayers:* Taxpayers now using the alternative tax will pay higher taxes on the first $50,000 of their long-term capital gains. The special income averaging rules provide relief for taxpayers who have occasional large capital gains.
In 1974, the most recent year for which information is available, of the 5.4 million taxpayers reporting capital gains, 76,317, or less than 1.5 percent, elected the alternative tax.

*Effect on Revenue:* This proposal will increase tax liabilities $100 million in calendar year 1979. [Fact Sheet # 17.]

## D. Fringe Benefits Unavailable to Rank-and-File Workers

Our system generally operates under the principle that employees should be taxed on their compensation no matter what form that compensation assumes. A worker who receives cash wages that he uses to provide benefits for his family should not ordinarily be taxed more heavily than the employee who receives those benefits directly from his employer. There are now exceptions to this general rule for certain types of employee benefits. I urge Congress to act so that these tax preferences benefit rank-and-file workers as well as the executive officers.

(1) *Non-discrimination Requirement for Health and Group Life Plans.* An example of a tax-preferred employee benefit is a health or group life insurance plan. If an individual purchases medical insurance, the premiums are deductible only within the limits applicable to the medical expense deduction. However, if an employer establishes a medical insurance program for its employees, the premium payments by the employer are deductible while neither the premiums nor the benefits are taxable to the employee.

Although this tax preference was designed in theory to secure basic protections for a wide range of employees, it often serves instead to subsidize expenses of only the high-level corporate managers. It is now possible for a businessman, through his controlled corporation, to establish a health plan that covers only one employee — himself — and permits all of his medical and dental expenses to be deducted. Meanwhile, that corporation's other employees have to provide health care for their families with non-deductible expenditures.

To curb this abuse, I recommend denial of the tax exemption for employer-established medical, disability, and group life insurance plans if those plans discriminate in favor of officers, shareholders, and higher-paid employees. Preferential tax treatment is now available to pension plans only if non-discrimination standards are met. The tax law should require similar non-discriminatory treatment for workers in the case of medical, disability, and group life insurance plans.

(2) *Employee Death Benefits.* Current law provides an exclusion for the first $5,000 of payments made by an employer on account of the death of an employee. I recommend the repeal of this exclusion. Typically, these death benefits are in the nature of deferred wages that would have been paid to employees in high tax brackets. Adequate tax relief for an employee's heirs is provided through a complete tax exemption for insurance proceeds.

(3) *Integration of Qualified Retirement Plans and Social Security.* Certain employer-sponsored retirement plans have a preferred tax status. Employer contributions to a qualified plan are currently deductible while the employee can defer taxation until retirement benefits are received. Although qualification for this special treatment is generally dependent upon non-discriminatory coverage of employees, the tax laws now permit a qualified plan to cover only employees who earn amounts exceeding the social security wage base — a base that will rise to $25,900 by 1980 under the recently enacted social security financing legislation.

It is unfair to grant tax preferences for private pension plans that bar all low and middle-income employees from participation. I propose that a new integration formula be enacted so that a qualified pension plan cannot provide benefits to supplement social security for highly compensated employees unless all employees receive some coverage under the plan.

## E. Unemployment Compensation

Unemployment compensation is a substitute for wages that generally provide needed relief to persons in financial distress. But, in some cases, the unemployment compensation system discourages work for taxable income. Since unemployment benefits are tax-free, they are more valuable than an equivalent amount of wages. This means that if two individuals have the same total income, the one who remains idle several months and receives unemployment compensation will be better off financially than his colleague who works the whole year. There can be no justification for conferring this tax-free benefit upon middle and upper-income workers.

I propose that the current tax exemption for unemployment compensation benefits be phased out as an individual's income rises above $20,000 for single persons or $25,000 for married couples.

## F. Taxable Bond Option and Industrial Development Bonds

Present law exempts from Federal taxation the interest on certain bonds issued by state and local governments. There are now two general categories of tax-exempt bonds: obligations issued for the benefit of the state and local government itself, and industrial development bonds issued by the government to provide facilities such as pollution control equipment, sports facilities, waste disposal facilities, industrial parks, and facilities (including hospitals) of private, non-profit organizations. Also, there is a "small issue" exemption for certain industrial development bonds with face amounts that do not exceed $1 million, or $5 million where the total cost of capital expeditures on the financed facility does not exceed the $5 million amount.

My tax program preserves the freedom of state and local governments to issue tax-exempt bonds. I am recommending reforms that will restrict the tax avoidance opportunities available to the wealthy in the tax-exempt market while, at the same time, increasing the ability of state and local governments to obtain low-cost financing. In particular, I propose the following:

(1) *Option for Bonds Benefitting Governmental Units.* State and local governments will be given the option of continuing to issue tax-exempt bonds or issuing fully taxable bonds, accompanied by a direct Federal interest subsidy to the governmental units. For bonds issued in 1979 and 1980, the subsidy will be equal to 35 percent of the interest cost; the subsidy will rise to 40 percent for bonds issued after 1980. The Federal government will exercise no control over the purposes for which state and local governments use subsidized financing. State and local governments will benefit under the taxable bond option regardless of whether they decide to issue taxable or tax-exempt bonds: those issuing taxable bonds will benefit directly from the interest subsidy, and those continuing to issue tax-exempt bonds will benefit because the reduced supply of such bonds will allow governments to sell them at lower interest rates.

(2) *Pollution Control Bonds, Bonds for the Development of Industrial Parks, and Private Hospital Bonds.* The tax exemption will be removed for interest on pollution control bonds and bonds for the development of industrial parks. Also, the exemption will be removed for bonds issued to finance construction of hospital facilities for private, non-profit institutions unless there is a certification by the state that a new hospital is needed. These activities are essentially for the benefit of private users, and the tax exemption for the bonds has the effect of undermining the financing of governmental functions. Moreover, the general exemption for hospital bonds encourages excessive expansion of unneeded hospital facilities and runs counter to the Administration's Hospital Cost Containment proposal.

(3) *Small Issue Exemption.* The existing "small issue" exemptions will be retained only for economically distressed areas; and, with respect to those areas, the $5 million exemption will be raied to $10 million.

(4) *Option for Certain Industrial Development Bonds.* Industrial development bonds which continue to enjoy tax-exempt status (such as those to finance sports facilities, housing, airports and convention facilities and small issues for economically distressed areas) will be eligible for the taxable bond option on the same terms as obligations issued for the benefit of state and local governments.

## G. Accrual Accounting for Large Corporate Farms

Most taxpayers that are in the business of selling products must use an accrual method of accounting so that income is reflected accurately for tax purposes. However, farmers have historically been permitted to use the simpler cash methods on the grounds that they lack the accounting and bookkeeping expertise required by the accrual system.

Congress acted in 1976 to deny the cash accounting privilege to most large corporate farms (with annual gross receipts exceeding $1 million), but retained an exception for large corporations that are "family owned." This distinction between family and non-family corporations bears no relationship to the rationale of preserving simple bookkeeping methods for small farmers. It has resulted in severe competitive imbalances between large corporations now required to use accrual accounting and those that are equally large but happen to fall within the definition of a "family farm."

This inequitable exception should now be eliminated. Corporate farms with gross receipts exceeding $1 million cannot fairly claim that they lack the sophistication necessary to comply with accrual accounting standards. Nor can lack of financial sophistication be claimed by farm syndicates used as investment vehicles by non-farmers. Therefore, I recommend that the accrual accounting requirement cover corporations with gross receipts greater than $1 million, regardless of their ownership, and all farm syndicates.

## H. Tax Treatment of Financial Institutions

Financial institutions now have a favored tax status that is based largely on outmoded concepts regarding the nature of these businesses. Commercial banks, mutual savings banks and savings and loan associations were permitted to deduct artificially inflated reserves for bad debts in order to protect the banking system from catastrophic losses that were prevalent prior to the extensive banking legislation of the 1930's. Credit unions were exempted from taxation in the days when these institutions were small entities with close bonds among the members and few powers to provide extensive financial services. I am recommending changes that will recognize the contemporary practices of financial institutions and will bring the tax treatment of commercial banks, savings and loan associations and credit unions more in line with the taxation of other businesses. These reforms will raise $300 million per year in revenue.

(1) *Commercial Banks.* Commercial banks may not claim bad debt deductions that greatly exceed their actual losses. Under legislation enacted in 1969, this spe-

cial bad debt deduction is scheduled for elimination after 1987. I propose that the effective date for repeal be accelerated so that beginning in 1979 banks, like other businesses, will base their bad debt reserves on their own experience in the current and 5 preceding years.

(2) *Mutual Savings Banks and Savings and Loan Associations.* Mutual savings banks and savings and loan associations are also permitted a special bad debt deduction that bears no relationship to actual experience. These thrift institutions are generally entitled to deduct 40 percent of their net income (this percentage is scheduled to apply in 1979) as a bad debt reserve as long as a significant portion of their deposits is invested in real estate loans. My tax program will reduce the percentage to 30 percent over a 5-year period.

(3) *Credit Unions.* Credit unions are tax-exempt. Yet, their powers and functions are defined so broadly that the term "credit union" can include financial institutions that are functionally identical to a savings and loan association. The tax exemption provides them with an unfair financial advantage over their competitors. I propose that the percentage of exempt income be phased out over a 4-year period, and that credit unions be taxed in the same manner as mutual savings banks and savings and loan associations after 1982.

## I. Domestic International Sales Corporation (DISC)

Business incentives form an integral part of my tax program. I am recommending measures that will encourage American businesses to invest in productive facilities and to create jobs. However, adoption of those incentives must be accompanied by the elimination of tax preferences that have proved to be wasteful. The so-called "DISC" provision is a prime example.

In 1971, Congress enacted a special tax program for exports. This program permitted tax benefits for exports channeled through a company's specially created subsidiary, usually a paper organization, known as a domestic international sales corporation (DISC). Artificial pricing rules on transactions between the parent company and its DISC permit a favorable allocation of export profits to the DISC, and the taxation of one-half of eligible DISC income is deferred as long as these profits are invested in export related assets.

DISC has proved to be a very inefficient and wasteful export subsidy in the current international monetary system. A recent Treasury study indicates that DISC may have contributed only $1,000 to $3,000 million to U.S. exports in 1974 — an increase of less than 3 percent in total exports — at a tax revenue cost of $1,200 million. In the long run, even these increased exports are probably offset by rising imports that result from the operation of the flexible exchange rate system. DISC does nothing for, and may even disadvantage, our import sensitive industries and our exporters not using the DISC provision. Independent experts believe that DISC may have no positive effect on our balance of payments.

Congress has recognized the wasteful nature of DISC and, in 1976, limited its applicability. However, DISC continues to cost U.S. taxpayers over $1,000 million per year, with 65 percent of DISC benefits going to corporations with more than $250 million in assets.

I propose the elimination of one-third of DISC benefits in 1979, two-thirds in 1980, and all DISC benefits in 1981 and thereafter.

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*The President's Proposal:* DISC tax benefits will be reduced by one-third in 1979, and two-thirds in 1980, and 100 percent in 1981 and thereafter.

*Present Law:* U.S. corporations may defer tax on a portion of their export-related income by channeling it through a domestic subsidiary, usually a paper company, called a Domestic International Sales Corporation (DISC). Special pricing rules on transactions between the parent and its DISC permit a favorable allocation of profit to a DISC. Prior to 1976, the taxation of half of a DISC's income was deferred as long as these profits were invested in export-related assets. In 1976 the portion of the income eligible for deferral was further limited to income in excess of 67 percent of the company's average export income in a moving base period. The purpose was to limit the benefits to increase export activity and to deny them where the exports would clearly have occurred anyway.

*Reasons for the Recommendation:* DISC has turned out to be a far more costly and less effective program than originally claimed. There are more effective and evenhanded means of providing tax relief to business. A recent Treasury study indicates that DISC may have contributed only $1,000 million to $3,000 million to U.S. exports in 1974 (less than 3 percent of U.S. exports for that year) at a tax revenue cost of $1,200 million. DISC was conceived as a means of reducing American export costs when exchange rates were fixed. Changes in flexible exchange rates now provide a far better means of adjusting to changes in the competitive position of U.S. exports.

*Effect on Taxpayers:* The tax savings from using DISCs will be eliminated over 3 years.

*Effect on Revenue:* This proposal will increase tax liabilities $700 million in calendar year 1979, rising to $1,800 million in calendar year 1983. [Fact Sheet # 26.]

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## J. Foreign Tax Deferral

Domestic corporations can now avoid paying a U.S. tax on the earnings of their foreign subsidiaries as long as those earnings remain overseas. A U.S. tax is generally deferred until dividends are paid by the subsidiary to its domestic parent, and then U.S. tax liability is offset by a tax credit for foreign income taxes paid on those remitted earnings. Fifty percent of all the benefits of tax deferral is obtained by 30 large multinational corporations.

I recommend that this deferral privilege be phased out over a 3-year period. At lease one-third of a foreign subsidiary's earnings will be taxed to the U.S. parent in 1979, at least two-thirds in 1980, and all the subsidiary's earnings after 1980. The tax reform program is designed to create incentives for investment in the United States and the creation of jobs for American workers. Tax deferral runs counter to these objectives. By providing a preference for foreign source income, the current deferral provision provides an incentive for investing abroad rather than in the United States, thereby having the effect of reducing job opportunities for Americans. Moreover, deferral can encourage multinational corporations to manipulate internal transfer prices in order to allocate income to low-tax countries.

There is no reason to defer the imposition of a U.S. tax just because business operations are conducted abroad rather than in the United States, regardless of the motivation for creating a foreign subsidiary. Congress eliminated in 1969 certain special tax preferences for businesses conducted in the United States through multilayered corporations. I propose that Congress act in a similar manner to end the present preference for business operations conducted internationally through such multinational corporate structures.

The foreign tax credit will be retained in its present form. Therefore, elimination of deferral will not result in a double taxation of overseas earnings. And, in the event it appears to be in the national interest to permit tax deferral with respect to specific countries, such treatment can be provided selectively under negotiated tax treaties involving mutual concessions.

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*The President's Proposal:* "Tax deferral" of earnings of U.S.-controlled foreign corporations will be phased out over a 3 year period by treating an appropriate fraction — one-third in 1979, two-thirds in 1980, and the entire amount in 1981 and thereafter — of a controlled foreign corporation's gross income, deductions, and taxes eligible for the foreign tax credit as having been earned or incurred directly by the U.S. shareholder. The earnings of a U.S.-controlled foreign corporation will be taxed currently whether or not those earnings are paid to the U.S. shareholders (usually parent companies) as dividends.

Foreign taxes in excess of the amounts that may be credited against U.S. taxes in any one year will be usable to offset U.S. taxes imposed for 3 years in the past. They may also be carried forward to offset U.S. taxes for 7 years in the future. (The carryback and carryforward periods are now 2 and 5 years respectively).

U.S. shareholders will be allowed to claim losses incurred by their controlled foreign corporations.

Unrealized gains and losses, resulting from changes in the value of the U.S. dollar as compared to other currencies, will not be taken into account unless the U.S. shareholder elects. That election may be revoked 10 years after it is made with respect to future tax years only.

U.S. shareholders may be allowed to continue to defer the payment of taxes on certain types of income under specific tax treaties.

*Present Law:* Generally, income from a controlled foreign corporation is not taxed to the U.S. shareholder until it is distributed in the form of dividends. This provision is referred to as "tax deferral" on the earnings of U.S.-controlled foreign corporations.

There are exceptions for controlled foreign corporations that have what is known as tax haven income and for foreign personal holding companies. Certain other provisions of the tax law prohibit the shifting of income or deductions for tax avoidance purposes. For example, one provision requires arm's length prices for transactions between a corporation and its controlling shareholders to prevent shifting income from a country imposing higher taxes to one where taxes are lower.

Another provision attempts to insure that reorganizations involving foreign corporations are not for tax avoidance purposes by generally treating the reorganizations as taxable events. Other sections of the law provide rules for determining whether income is from domestic or foreign sources and allocating deductions to the appropriate source of income.

*Reasons for the Recommendation:* By eliminating tax deferral, U.S. businesses will have no incentive to invest overseas solely for the tax benefits available. The proposal will end any adverse effects on investment in the United States and on the creation of domestic jobs that may result from tax deferral.

Also, these provisions will lessen the incentives U.S. corporations now have to manipulate their international operations to avoid U.S. taxes.

The current tax laws and regulations relating to foreign corporations and international business transactions are so complicated that only the largest companies can afford the cost of sophisticated tax planning. This creates a definite competitive disadvantage for the smaller companies and those more oriented toward operations within the United States.

*Effect on Taxpayers:* The incentive for U.S. companies to invest in foreign countries simply because they provide special tax advantages will be greatly reduced. Generally, taxpayers will no longer be required to interpret the extremely difficult sections of the tax laws and regulations relating to foreign corporations.

*Effect on Revenue:* The proposed change will increase tax liabilities $100 million in calendar year 1979, rising to $900 million in calendar year 1983. [Fact Sheet # 27.]

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## II. REDUCTION OF COST

### A. Repeal of Excise Tax on Telephone Services

The present 4 percent excise tax on amounts paid for telephone services is now being phased out at the rate of 1 percentage point a year, with full repeal scheduled as of January 1, 1982.

I recommend complete repeal of this tax as of October 1, 1978. This action will reduce the cost of living directly. It will also lower consumer prices indirectly through a reduction of the business cost associated with telephone services.

### B. Federal Unemployment Insurance Tax

I recommend a reduction in the Federal unemployment insurance tax to reduce the payroll costs of employers. On January 1, 1978, the unemployment insurance tax rate rose from 0.5 percent to 0.7 percent of an employer's taxable wage base. This tax increase was instituted in order to replenish general revenue funds that have been loaned to the unemployment insurance trust fund during recent periods of high unemployment. But the issue of unemployment compensation financing requires a thorough reexamination to determine the best means of providing future benefits. To this end, I will soon appoint the National Commission on Unemployment Insurance which the Congress established to make this study and to offer recommendations. In the meantime, I am guided by my concerns about inflation. I propose that the tax rate be reduced to the 0.5 percent level as of January 1, 1979.

## III. TAX INCENTIVES FOR BUSINESS TO FOSTER GROWTH OF THE ECONOMY

### A. Corporate Rate Cut

I recommend a corporate rate cut that will reduce business taxes by $6,000 million. Tax relief in this form is sizable, easily understood by taxpayers, and applicable across the board.

The corporate tax rate is now 20 percent on the first $25,000 of income, 22 percent on the next $25,000, and 48 percent on corporate income exceeding $50,000. Effective October 1, 1978, this program will reduce the first two rate brackets to 18 and 20 percent, respectively, and the rate to 45 percent on taxable income in excess of $50,000. The top rate will be reduced an additional point, to 44 percent, on January 1, 1980. Small as well as large corporations will benefit from these rate cuts.

A corporate rate reduction of this magnitude will increase capital formation and help to assure a sustained economic recovery. In recent years, the level of business fixed investment has been unsatisfactory. One of the primary causes of this inadequate investment performance has been the low rate of return businesses receive on their investments — after tax liability is taken into consideration. The lower tax rates I recommend will enhance the anticipated after-tax profits on corporate investment projects and increase cash flow immediately. Businesses will thereby be encouraged to increase capital spending and to create jobs for American workers. Corporate rate cuts this large are made possible by, and depend upon, passage of the revenue-raising business tax reforms I have described earlier.

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*The President's Proposal:* The corporate tax rate on taxable income in excess of $50,000 will be reduced permanently by three percentage points to 45 percent effective October 1, 1978, with an additional reduction of one percentage point on January 1, 1980. The rate applied to the first $50,000 of taxable income will be reduced by two percentage points effective October 1, 1978.

*Present Law:* The present corporate tax rates are 20 percent on the first $25,000 of taxable income, 22 percent on income in excess of $25,000 up to $50,000, and 48 percent on all income in excess of $50,000.

*Reasons for the Recommendation:* These tax reductions, together with the extension of the investment credit, will assure the continuance and strengthening of the present economic recovery and will promote long-term capital formation. Increased capital formation can contribute both to economic demand needed for continued economic expansion and to increased productive capacity that will help avoid bottlenecks and inflationary pressures as the economy moves ahead.

The portion of GNP devoted to investment needs to be increased in the year ahead. Moreover, the efficient use of new capital needs to be assured. Additional jobs are needed for a growing labor force, to meet the goals of the National Energy Plan and to provide a cleaner environment and safer workplaces. The real income of workers can grow over the long run only if productivity is enhanced with new machinery and more efficient plants. Dependence on foreign oil can be minimized only if electric utilities and industrial plants acquire the new capital necessary to convert to coal and other non-petroleum fuels. An improved environment and safer jobs also requires new facilities.

The corporate tax reductions are designed to spur the economy by stimulating capital formation. First, the lower taxes will have an immediate, favorable effect on corporate cash flow. Because retained earnings are the principal source of financing for corporate investments, the improved cash flow will provide for more capital expenditures. Second, the lower tax rates will increase after tax profits on investment projects. This improved return on investment will be an incentive for corporations to increase capital spending. Additionally, an increase in corporate dividends and the prospective growth in share prices resulting from higher after-tax earnings will stimulate the public to place more of their savings in corporate equities.

*Effect on Taxpayers:* The proposal will provide an immediate, direct tax reduction for both large and small corporations.

*Effect on Revenue:* For calendar year 1979, the rates are estimated to reduce corporate income tax liabilities $6,000 million. [Fact Sheet # 30.]

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### B. Liberalization of Investment Tax Credit

The investment tax credit has proven to be one of the most potent tax incentives for capital formation. It provides a direct reduction in tax liability generally equal to 10 percent of a business' qualifying investments. But there are now several limitations that restrict its effectiveness.

I recommend changes that will make the investment credit a stronger, more efficient, and more equitable incentive. These changes will reduce business taxes by approximately $2.5 billion per year.

(1) *Permanent 10 Percent Credit.* The present 10 percent investment credit is not a permanent feature of the Internal Revenue Code. On January 1, 1981, the credit level is scheduled to revert to 7 percent. I propose that the credit be extended permanently at a 10 percent rate so that businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

(2) *Increased Tax Liability Ceiling.* The investment credit claimed during any taxable year cannot generally exceed $25,000 plus 50 percent of tax liability in excess of that amount (with excess credits being eligible for a 3-year carryback and a 7 year carryforward). My tax program will provide a ceiling of 90 percent of tax liability (including the first $25,000) and will thereby increase the incentive for those businesses with relatively high investment needs and low taxable incomes. Developing businesses and firms suffering from temporary business reversals will be helped to compete more effectively with their larger or more stable competitors.

(3) *Eligibility of Structures.* The investment credit now applies only to machinery and equipment. My tax program will extend eligibility for the credit to utility and industrial structures, where investments have been especially sluggish. Investment in these structures reached its peak over 4 years ago and is now 16 percent below that level. It is important that we act to remedy the existing tax bias against structures and encourage balanced industrial expansion. In order to ensure that

this provision has no anti-urban bias, I propose that the investment credit be available for both new structures and the rehabilitation of existing structures.

I recommend that this provision apply to construction costs incurred after December 31, 1977. In the case of new structures, there will be an additional requirement that the facility be placed in service after that date.

(4) *Liberalized Credit for Pollution Control Facilities.* I propose that pollution abatement facilities placed in service after December 31, 1977, be allowed to qualify for a full 10 percent credit even if special 5-year amortization is claimed under the provisions of existing law. Currently, only a 5 percent credit may be combined with rapid amortization. This proposal will provide significant tax relief for industries that are forced to make pollution control expenditures in order to comply with environmental regulations.

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*The President's Proposal:* The temporary 10 percent investment credit will be made permanent.

The investment credit will be extended to new industrial buildings and to investments made to rehabilitate existing industrial buildings. Generally only manufacturing and utility buildings will be eligible for the credit. Industrial structures placed in service after December 31, 1977 will be eligible for the credit to the extent of construction costs incurred after that date. Expenditures made after December 31, 1977 to rehabilitate existing industrial structures will be eligible for the credit.

Investment credits will be allowed to offset 90 percent of tax liability in any year. They will not be permitted to offset a taxpayer's complete tax liability.

The full 10 percent investment credit will be extended to pollution control equipment that now qualifies for the special 5-year amortization.

*Present Law:* The 10 percent rate of the investment credit is scheduled to revert to 7 (4 for utilities) percent on January 1, 1981.

The investment credit is available for investment in business machinery and equipment but not for investment in buildings or their structural components.

Investment credits may be used to offset all of the first $25,000 of tax liability, but no more than 50 percent.

Certain qualified pollution control equipment is now eligible for a maximum investment credit of only 5 percent if the taxpayer elects to amortize the cost of this equipment over a 5-year period.

*Reasons for the Recommendation:* Together with the recommended 4 point reduction in the corporate tax rate, the proposed liberalization of the investment credit will help stimulate increased levels of business investment.

A particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures. The investment stimulus provided by the credit should, therefore, be extended to investments in industrial structures.

Increased investment is also needed to improve the capacity of the economy to supply goods and services and to insure that future growth is not aborted by capacity shortages.

The declining rate of business investment is related to a slowdown in the growth of productivity. Increased capital formation can help accelerate the growth of productivity, maintain and improve American competitiveness in world markets, and facilitate the introduction of new technology.

A permanent credit is necessary to assist businesses in making long-range capital investment decisions and to stimulate capital formation.

Extending the investment credit to industrial structures will encourage businesses to carry out more balanced investment programs. Also, under present law, there are many disputes now caused by the need to distinguish between equipment for which the credit is available, and buildings and their structural components, for which it is not.

New businesses and businesses facing temporary setbacks or the need to make major adjustments to economic changes cannot fully use the investment credit because of the 50 percent limit on offsetting current tax liability.

*Effect on Taxpayers:* The proposal will reduce the overall tax burden on business.

Increasing the percentage of tax liability that can be offset by investment credits to 90 percent will aid companies with large investment needs and relatively low taxable incomes.

Taxpayers with tax liabilities of less than $25,000 will no longer be able to use investment credits to offset their entire tax liability.

The increased investment credit for certain pollution control equipment will reduce the costs of compliance with environmental standards in the case of existing plants, many of which were constructed when pollution control standards were less stringent.

*Effect on Revenue:* These proposals will reduce tax liabilities approximately $2,400 million in calendar 1979, the first full year of the proposed changes.

By 1963, it is estimated that the proposed changes will reduce tax liabilities $7,200 million, of which $4,500 million is attributable to permanent extension of the 10 percent credit. [Fact Sheet # 31.]

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## C. Revision and Simplification of Regulations Under the Asset Depreciation Range System

The asset depreciation range (ADR) system provides substantial tax benefits to businesses. Under ADR, generous class lives are prescribed for categories of assets, and a taxpayer can select useful lives for depreciation purposes within a range that extends from 20 percent below to 20 percent above the designated class life. However, certain complexities in the ADR regulations discourage most businesses, especially small ones, from electing this depreciation system and impose administrative burdens on those businesses that do use ADR.

I recommend legislation expressly permitting the Treasury Department to issue reglations that will simplify the ADR system. Included among the changes will be a termination of the annual reporting requirement.

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*The President's Proposal:* The Asset Depreciation Range (ADR) system, which establishes procedures for taxpayers to depreciate their assets, will be simplified.

Salvage value will be disregarded under the revised system. Elaborate reporting requirements will be replaced by Treasury surveys which will require responses from only a small number of taxpayers each year. Only the straight-line and declining balance methods of depreciation will be allowed under ADR.

*Present Law:* Under the ADR system, the IRS prescribes a range of guideline lives which taxpayers can use in setting the useful lives of their assets. Use of these lives by a taxpayer avoids disagreements between the taxpayer and IRS agents on salvage audit as to what are the proper useful lives of the taxpayer's assets.

Estimated value in excess of 20 percent of cost limits the extent to which depreciation can be taken under ADR.

Taxpayers electing ADR are permitted to use the sum of the years' digits, the 200 percent declining balance, and the straight-line methods of depreciation.

The ADR system, which was intended to simplify depreciation, occupies twenty pages in the printed regulations. Part of this length is due to the elections available to taxpayers in computing depreciation.

*Reasons for the Recommendation:* Only about one half of one percent of all corporate taxpayers elected ADR in the last year for which figures are available (1974). However, over 90 percent of taxpayers with depreciable assets of greater than $1,000 million elected ADR. More taxpayers will be encouraged to use a simplified ADR system, and the IRS will gain the administrative benefits which ADR provides.

Eliminating the yearly reporting requirement will remove a significant burden from taxpayers who wish to adopt ADR. Surveys will provide the Treasury with sufficient information to keep current the figures needed for setting useful lives under ADR.

By eliminating some of the elections available to taxpayers under ADR, the description, application, and administration of ADR will be substantially simplified.

*Effect on Taxpayers:* The proposal will make the ADR system accessible to a greater number of taxpayers.

*Effect on Revenue:* This proposal will have a negligible impact on revenue. [Fact Sheet # 32.]

## D. Proposals Focused on Small Business

The tax reductions I recommend will provide significant benefits for small businesses. For example, a small corporation with annual income of $50,000 will save $1,000 in taxes due to corporate rate reductions. For that corporation, tax liability will be reduced by nearly 10 percent. Moreover, those small businesses conducted in partnership or sole proprietorship form will benefit substantially from the rate cuts I have proposed for individuals.

But in addition to providing these general tax incentives, I recommend three proposals designed specifically to assist small businesses. First, my tax program will simplify and liberalize the rules (Subchapter S) that treat certain small corporations as partnerships; the number of permissible shareholders will generally be increased from 10 to 15, and the rules governing subchapter S elections will be made less stringent. Second, a simplified method of depreciation will be authorized for small businesses that will provide tax benefits similar to the current ADR system without complex recordkeeping requirements. And third, risk-taking will be encouraged by doubling the amount of a small corporation's stock (from $500,000 to $1 million) that can qualify for special ordinary loss treatment and by eliminating several technical requirements that needlessly restrict the ability of small businesses to use this provision.

## Conclusion

Enactment of these recommendations will effect major reform of our tax laws, provide significant tax relief, and sustain our economic recovery.

This program will eliminate a number of the inequities that undermine the integrity of the tax system. It will make preparation of returns simpler and more understandable for millions of taxpayers. Prompt passage will strengthen the confidence of consumers and businesses in our growing economy and lead to the creation of up to one million new jobs for workers who need them.

I look forward to working in partnership with Congress to enact this program of tax reform and tax reduction.

# U.S. Taxation of Non-Resident Citizens

by Thomas C. Geiser*

*The Tax Reform Act of 1976 (TRA) introduced changes respecting the taxation of non-resident United States citizens which could profoundly affect the position of American individuals and enterprises abroad.*

*By curtailing the availability of various tax benefits to these taxpayers, who are subject to U.S. taxation on their world-wide income, the TRA generated a storm of protest. This reaction resulted in one postponement of the effective date of these controversial provisions, and another postponement is likely, which will give Congress an opportunity to reconsider the international impact of the position adopted in the TRA. This article will present an overview of the U.S. taxation of Americans employed abroad and the competing policies and proposals which may soon alter this situation.*

## I. INTRODUCTION

The United States, unlike most countries, imposes income tax on the world-wide income of its non-resident citizens,[1] thereby subjecting them to both U.S. income tax and any tax imposed by the foreign country where the income was realized. Congress, however, has provided for unilateral relief in the form of tax credits for foreign taxes paid or accrued and a limited exclusion of foreign-source earned income from the taxpayer's gross income. It is the TRA's reduction of the amount of this earned income exclusion that is the focal point of recent protests by American expatriates.

The Revenue Act of 1926 [2] introduced the concept of the earned income exclusion as a means of stimulating increased foreign trade. The exclusion was modified over the years principally to curb abuses by movie stars operating abroad. Internal Revenue Code Sec. 911 provided, prior to the enactment of the TRA, that a U.S. citizen who was either (1) a bona fide resident of a foreign country for an uninterrupted period that included an entire taxable year (bona fide resident test) or (2) physically present in a foreign country for 510 days (17 months) out of a period of 18 consecutive months (physical presence test) could exclude $20,000 of earned income derived from sources outside the United States from his or her gross income. Moreover, U.S. citizens who were bona fide residents of a foreign country for three consecutive years were entitled to a $25,000 earned income exclusion.

The income exclusion was limited to sums received as wages, salaries, professional fees or compensation for personal services actually rendered. In addition, amounts paid by the United States or an agency thereof and amounts received as a pension or annuity could not be excluded. However, the taxpayer was unilaterally granted the benefit of reducing his tax liability by claiming a tax credit for foreign taxes paid or accrued which were allocable to the excluded income.

## II. THE TAX REFORM ACT OF 1976

The Tax Reform Act of 1976 amended Internal Revenue Code Section 911 to reduce the tax benefits granted to U.S. citizens working abroad. The provisions eventually adopted were the product of a compromise between the House of Representatives, which advocated eliminating the earned income exclusion altogether to remedy what was perceived as an unfair advantage granted non-residents at the expense of residents, [3] and the Seneate, which felt that despite revenue considerations the exclusion should be retained in order to maintain the competitiveness of U.S. firms abroad. [4]

The ensuing legislation introduced the following major changes in the taxation of non-resident U.S. citizens: the amount of the earned income exclusion was reduced; limitations were imposed with respect to foreign tax credits and income received outside the country where earned; the rate of tax applicable to non-excluded income was increased; and taxpayers were given the option of not using the earned income exclusion at all. The bona fide resident [5] and physical presence [6] tests were retained, while the increased exclusion for those residing abroad for three years was eliminated. The definition of earned income [7] remained the same, as did the rules respecting sums received from the United States [8] and pensions and annuities. [9]

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* Associate Editor of loose-leaf publications at the International Bureau of Fiscal Documentation.

1. Internal Revenue Code Sec. 61.
2. Sec. 213(b)(14).
3. See H. Rept. 94-658, 94th Cong. 1st Sess. 200 (1975).
4. See S. Rept. 94-938, 94th Cong. 2d Sess. 210 (1976).
5. I.R.C. Sec. 911(a)(1).
6. I.R.C. Sec. 911(a)(2).
7. I.R.C. Sec. 911(b).
8. I.R.C. Sec. 911(a)(1), (2).
9. I.R.C. Sec. 911(c)(5)(A).

These provisions were to have become effective for taxable years commencing after December 31, 1975, but protests by non-resident taxpayers resulted in Congressional action delaying the effective date to taxable years after December 31, 1976. [10] In late 1977, the House of Representatives approved the postponement of the provisions' effective date for another year. However, this measure failed to be approved by the Senate during 1977, with the result that the TRA provisions became effective. Nevertheless, it is most likely that yet another one year postponement will be enacted in early 1978 to allow the reconsideration of the entire system governing the taxation of non-resident citizens. As the 1977 tax returns of such taxpayers are not due until June 15, 1978, [11] a strong possibility exists that the TRA provisions as originally drafted will not apply to the 1977 tax year.

### A. Reduction of the earned income exclusion

The TRA eliminated the $20,000 and $25,000 amounts of earned income which were previously excludable and substituted a $15,000 limit. [12] A limited exception allows employees performing "qualified charitable services" for a charitable organization to exclude up to $20,000 of earned income annually. [13] Such a charitable organization must be established in the United States or a political subdivision thereof, and it must be a religious, scientific, educational or similar organization that is exempt from taxation under the Internal Revenue Code. A special rule governing the exclusion limit in the case of employees performing both charitable and non-charitable services during a taxable year looks first to the income derived from charitable services. The amount of income from non-charitable services which may be excluded is then limited to $15,000 minus the amount of income from "qualified charitable services" which is excludable. [14]

The reduced limit of the earned income exclusion, coupled with the higher rate of tax imposed on non-excluded income under the TRA (see II.B., infra), will require employers to adjust their rates of withholding U.S. income tax. However, it should be noted that U.S. tax need not be withheld on wages and salaries when an employer could reasonably believe that the amount in question will fall within the earned income exclusion. [15] In addition, U.S. tax does not have to be withheld with respect to remuneration for services performed by a U.S. taxpayer in a foreign country when the employer is required to withhold income tax on such remuneration pursuant to the laws of any foreign country. [16]

### B. Tax rate applicable to non-excludable income

Along with reducing the amount of the earned income exclusion, the TRA provides that income in excess of the exclusion is to be taxed at the rates that would apply if there were no such exclusion. [17] Thus, non-excludable income is taxed at the taxpayer's highest tax brackets. Prior to the TRA, non-excludable income was taxed at the rate that would apply if there were no other income, thereby granting relief at the highest rates applicable to the individual's income.

The tax computation under the TRA is accomplished by taking the difference between the tax on the taxpayer's "net taxable income" and the tax on his "net excluded earned income". The following five steps can be used:

1) The amount of the earned income exclusion is taken and any deductions allocable to this amount (and thereby disallowed) are subtracted to produce "net excluded earned income".
2) The tax that would apply to "net excluded earned income" (step 1) if it were subject to tax is calculated.
3) The taxpayer's taxable income (non-excludable income) is then added to "net excluded earned income" (step 1) to produce "net taxable income".
4) The tax that would apply to "net taxable income" (step 3) if it were all subject to tax is computed.
5) The tax computed on "net excluded earned income" (step 2) is then subtracted from the tax calculated with respect to "net taxable income" (step 4) to produce the individual's tax liability, which may be reduced by any applicable tax credits (e.g. foreign tax credit).

### C. Limitations on foreign tax credit

Taxpayers may reduce their U.S. tax liability through credits for foreign income, war profits or excess profits taxes paid or accrued to foreign countries with respect to foreign-source income. [18] The TRA eliminated a substantial tax benefit permitted under prior law by stipulating that foreign taxes allocable to excluded income are no longer creditable. [19] Thus, no credits are available for foreign taxes paid or accrued on either the first $15,000 or $20,000 of income earned abroad unless the taxpayer elects out of the earned income exclusion. Such taxes were not allowed as deductions from gross income before the TRA, and this rule has been retained. [20]

Another change in the foreign tax credit rules which may affect expatriate Americans involves the basis for computing the available credit. Prior to the TRA, the allowable credit for foreign taxes could be calculated on a "per-country" basis. In other words, the amount of tax imposed by a particular country which could be credited against U.S. tax could not exceed the ratio which U.S. taxable income from that country bore to total U.S. taxable income (i.e. world-wide income). The TRA altered this rule to provide that the credit limitation could only be computed on an "overall" basis. [21] Thus, allowable credits against U.S. tax are limited to the ratio which the taxpayer's taxable income from *all*

10. Tax Reduction and Simplification Act of 1977, P.L. 95-30, Sec. 302.
11. Reg. Para. 1.6081-2.
12. I.R.C. Sec. 911(c)(1)(A).
13. I.R.C. Sec. 911(c)(1)(B).
14. I.R.C. Sec. 911(c)(1)(C).
15. I.R.C. Sec. 3401(a)(8)(A)(i).
16. I.R.C. Sec. 3401(a)(8)(A)(ii).
17. I.R.C. Sec. 911(d).
18. I.R.C. Sec. 901(b)(1).
19. I.R.C. Sec. 911(a).
20. Id.
21. I.R.C. Sec. 904(a).

foreign sources bears to his or her total taxable income (i.e. world-wide income):

$$\frac{\text{U.S. tax}}{\text{before credits}} \times \frac{\text{Taxable income from all foreign countries}}{\text{Total taxable income}} = \frac{\text{Maximum}}{\text{total credit}}$$

The "overall" limitation serves to offset losses incurred in one country against income realized in other countries. The amount of foreign-source income included in the above calculation is then reduced, thereby decreasing the available tax credit.

The TRA also imposed restrictions on the amount of capital gain income from sources outside the United States which could be included in the tax credit computation. Foreign-source capital gains must now be reduced by any capital losses from U.S. sources. [22] The result of this change is that there may be a reduction in the amount of capital gain available to increase total foreign-source taxable income, and consequently the available foreign tax credit may also be reduced.

In order to curtail the potential manipulation of foreign-source income, the TRA provides that capital gains from certain sales or exchanges of personal property outside the United States will be treated as U.S.-source income (precluding the use of foreign taxes paid for foreign tax credit purposes) unless the country where such a sale or exchange occurred imposed at least a ten percent rate of tax on the gain. [23] This rule will not apply when (1) an individual sells or exchanges the property in his country of residence, or (2) the property is sold or exchanged in a country where it was used in the individual's trade or business, or where the taxpayer derived more than 50 percent of his gross income for the three year period ending at the close of the taxable year prior to the year the sale or exchange was consummated.

Special rules prescribed for corporate taxpayers also strive to ensure that foreign sales of capital assets are not carried out solely for tax purposes.

## D. Earned income received outside country where services were performed

In contrast to the pre-TRA rule that all foreign-source earned income was eligible for the earned income exclusion, the TRA stipulates that the exclusion will be denied for income received outside its source country where one of the purposes for so receiving the income was the avoidance of taxes imposed by the country where the relevant services were performed. [24] It should be noted that tax avoidance need not be the principal or dominant purpose for the taxpayer receiving the income outside the country where it was earned. Tax avoidance need only be *one* of the taxpayer's purposes.

The Senate report on this provision indicates that a strong showing of a tax avoidance purpose is present when the country where the income was earned does not tax sums received outside its boundaries. [25] It is unclear whether the earned income exclusion would be denied for income received outside a source country which would not tax it if it had been received there, thus negating a tax avoidance purpose. Moreover, there is no rule respecting pro-rata allocations. Therefore, the question arises whether the exclusion would be denied to a non-resident who receives part of his or her taxable income in contravention of this tax avoidance provision, but who receives a full $15,000 of earned income which clearly qualifies for the exclusion.

## E. Election not to have provisions apply

The law prior to the TRA provided that the earned income exclusion would apply to all taxpayers who met either the bona fide resident test or the physical presence test, even if this application proved to be disadvantageous. The TRA amended Section 911 to allow taxpayers to elect not to have its provisions apply to them. [26] The exclusion under the TRA applies unless a taxpayer affirmatively elects to avoid its provisions. However, once this election has been made it cannot be revoked without the consent of the Secretary of the Treasury. A taxpayer must therefore carefully consider his or her future before making an election which could be permanently binding.

This election can prove to be advantageous to non-resident citizens living in countries with high effective tax rates, as they will be able to utilize for foreign tax credit purposes all foreign taxes paid or accrued instead of losing the credits that are now disallowed when the earned income exclusion applies (see II.C., supra). In addition, opting out of Section 911 allows the taxpayer to take full deductions for such items as moving expenses, rather than having to allocate and lose a part of them to the earned income exclusion.

## F. Miscellaneous provisions affecting non-resident U.S. citizens

### 1. *Standard deduction*

Taxpayers choosing to claim a credit for foreign taxes paid or accrued before the TRA were precluded from taking the standard deduction (a lump-sum deduction from income available to U.S. taxpayers without regard for deductible expenses actually incurred) and were required to itemize their deductions. The TRA makes the standard deduction available to those claiming a foreign tax credit, [27] a change which will generally benefit persons with small or moderate incomes in excess of the earned income exclusion.

### 2. *U.S. citizens married to non-resident aliens*

The Internal Revenue Code imposes personal income tax at four different rates, depending on the status of the taxpayer: one rate for married persons filing jointly, one for heads of households, one for unmarried individuals, and one for married persons filing separately. [28] Before the TRA, a U.S. citizen married to a non-

22. I.R.C. Sec. 904(b)(2).
23. I.R.C. Sec. 904(b)(3)(C).
24. I.R.C. Sec. 911(c)(8).
25. See S. Rept. 94-938, 94th Cong. 2d Sess. 211, 212 (1976).
26. I.R.C. Sec. 911(e).
27. I.R.C. Sec. 36, as amended.
28. I.R.C. Sec. 1.

resident alien could not file a joint tax return and was subject to the higher rate of tax applicable to married persons filing separately. The TRA permits the filing of a joint return in such a case, [29] thereby granting not only the advantage of the lower tax rate applicable to joint returns, but also allowing these taxpayers to utilize the 50 percent maximum tax rate on personal service income (which otherwise could be taxed at up to a 70 percent rate). [30]

In order to file jointly, both the U.S. citizen and the non-resident alien spouse must so elect and agree to be taxed on their world-wide incomes. This option is also effective for a non-resident alien who marries a U.S. citizen at any time during the taxable year with respect to the entire taxable year of the marriage. However, any election is terminated upon the death of either spouse, the issuance of a decree of divorce or separate maintenance respecting the marriage, or by the order of the Secretary of the Treasury upon the failure of the taxpayers to keep adequate records or supply necessary information. Once the election is terminated for any of these reasons it may never again be made by either spouse (e.g. it would be unavailable in the event of the non-resident alien spouse obtaining a divorce and subsequently marrying another U.S. citizen).

Another TRA change affecting U.S. expatriates alters the situation where a U.S. citizen employed in a foreign country with a community property system is married to a citizen of that country who is classified as a non-resident alien under U.S. tax law. Formerly, one-half of the U.S. taxpayer's income was deemed to be that of his or her spouse under the community property system and thus considered foreign income not subject to U.S. taxation. Nevertheless, the taxpayer was entitled to the entire earned income exclusion for the remaining one-half of his or her income.

The TRA eliminated this tax benefit by providing that income earned in this community property situation is deemed to be the income of the earner spouse and is not to be split. [31] The rule does not apply where a joint return election is made by a U.S. citizen and his or her non-resident alien spouse, in which case the entire world-wide income of both would already be subject to U.S. taxation.

*3. Non-resident citizens who rent their U.S. homes*

U.S. taxpayers who have used a dwelling unit as a personal residence at any time during the taxable year and then rent the dwelling unit to another person have had the availability of various deductions for expenses incurred reduced under the TRA. [32] A U.S. taxpayer who goes abroad and changes the status of his or her U.S. home from a personal residence to a rental property is limited in deducting such items as maintenance expenses and depreciation from gross rental income. The limitation becomes effective when the taxpayer has used the dwelling unit for "personal purposes" during the taxable year for the greater of 14 days or 10 percent of the number of days during the taxable year that the dwelling unit is rented for a fair rental price.

## III. RECENT DEVELOPMENTS

As mentioned above, the TRA changes respecting the taxation of non-resident citizens were originally to have become effective for taxable years beginning after December 31, 1975. However, protests from American expatriates led Congress to postpone the effective date of the provisions for one year, and although no further delay has been enacted (thus bringing the TRA provisions into effect), it is most likely that early 1978 will see the passage of a measure postponing the effective date until taxable years commencing after December 31, 1977.

Such a delay will permit Congress to consider various proposals for fundamentally altering the method of taxing Americans working abroad. The TRA provisions have been criticized for focusing on domestic tax policy and not taking into account their impact on U.S. interests and employment practices abroad. It has been pointed out that the new rules will have the greatest impact on Americans employed in the Middle East, where several countries impose no personal income tax and others frequently exempt foreign workers on particular projects from the payment of income tax. Thus, non-resident citizens and U.S. enterprises in this most important region will be greatly affected by the reduction in the earned income exclusion and the altered rules for computing tax liability. The opponents of the TRA have argued that the increased tax burden on non-residents will deter U.S. firms from sending employees abroad, thereby weakening U.S. competitiveness with foreign enterprises to an extent that outweighs any benefit represented by increased tax revenues.

On the other hand, supporters of the TRA provisions allege that non-residents should not be singled out for preferential treatment at the expense of domestic taxpayers. They point to the increased tax revenues that the TRA would generate, which have been estimated from $200 million to $400 million per year. Moreover, Senator William Proxmire recently gave his annual "Golden Fleece" award to the U.S. Treasury for supporting a delay in the effective date of the TRA provisions, citing the costs to resident taxpayers which the resulting loss in revenues would entail. Americans abroad were referred to in the award as "mink-swathed" individuals spending their "waking hours in gambling casinos in Monte Carlo" and as "high-living jetsetters living at the taxpayers' expense".

### A. Ribicoff bill

The criticisms of the TRA have resulted in the submission of a bill to Congress by Senator Abraham Ribicoff which proposes the replacement of the earned income exclusion with a series of special deductions. The bill would phase out the $15,000 annual earned income exclusion by 1980 by reducing it by $5,000 each year.

29. I.R.C. Sec. 6013(g).
30. I.R.C. Sec. 1348.
31. I.R.C. Sec. 879.
32. I.R.C. Sec. 280A.

Special deductions taking into account foreign living costs in excess of those experienced in the U.S. would then be allowed in lieu of the exclusion. These deductions would be in the areas of the general cost-of-living and the costs of education and housing.

The proposal attempts to eliminate what is perceived to be the weakness of the exclusion — its blanket application to all taxpayers irrespective of individual differences in living costs incurred. Proponents of the bill, who assert that the exclusion harms some taxpayers while granting a windfall to others, say that the deductions will grant tax relief commensurate with actual costs exceeding those typically encountered by domestic taxpayers. It is estimated that the bill would increase tax revenues derived from non-resident citizens, although not to the extent that the TRA would.

The bill stipulates that the Internal Revenue Service is to compile detailed statistics respecting the cost-of-living (excluding education and housing costs) in various foreign areas and the amounts by which these figures exceed the average cost-of-living in the United States. Adjustments for inflation would be made with the passage of time. The taxpayer would be allowed to deduct from his or her income the lesser of: (1) the figure computed by the I.R.S. reflecting cost-of-living expenses in the taxpayer's geographical area which exceed typical U.S. costs, or (2) any employer-paid cost-of-living allowance.

A deduction would also be allowed for education expenses. The Internal Revenue Service would again be required to compile a table showing the reasonable cost of education from kindergarten to grade 12 in "American-type" schools in different countries. The taxpayer would be allowed to deduct the smallest of:

(1) the amount reflected in the I.R.S. table,
(2) any employer-paid education allowance, or
(3) the amount actually expended for education.

A further deduction would be permitted for a portion of housing costs. The employee's base salary would first be computed by subtracting from his or her total salary any cost-of-living, education, housing and other employer-paid allowances. The taxpayer could then deduct from his or her income the amount yielded by subtracting 20 percent of this base salary from the lesser of (1) any housing allowance paid by the employer, or (2) the amount actually spent for housing. The 20 percent figure is considered to represent typical U.S. living costs, thus limiting the deduction to amounts in excess of those which would be borne in the U.S.

None of the special deductions would be available to taxpayers who do not receive special allowances from their employers for housing, education or the cost-of-living. However, special rules would permit the following classes of non-resident taxpayers to take the deductions: (1) self-employed persons, (2) employees of charitable organizations, (3) employees of foreigners not carrying on trade with the United States, and (4) employees who live in employer-furnished housing which is not deemed to constitute income under the Internal Revenue Code. Internal Revenue Service tables would be used in calculating the deductions.

### B. Treasury Department plans

The U.S. Treasury Department has responded to the controversy over Section 911 by drawing up several plans for revising the scheme of taxing non-resident citizens. One plan is said to be similar in many respects to the Ribicoff bill, but it apparently provides taxpayers with the option of taking a series of special deductions or an earned income exclusion.

As one alternative, taxpayers could choose to take special deductions for housing and education expenses. Costs in excess of between 15 and 20 percent of an individual's base salary (total salary less various employer-paid allowances) would be deductible for housing expenses. Education expenses incurred for dependent children would be deductible up to a ceiling amount. The Treasury Department plan differs significantly from the Ribicoff bill in disallowing any special deduction for excess cost-of-living expenses.

The plan would also allow taxpayers to take a $15,000 annual exclusion from gross income in lieu of taking these special deductions. Foreign taxes paid on the excluded amount might be allowed as a tax credit against U.S. tax due, which is the same situation that existed prior to the enactment of the TRA. However, the final form of the Treasury Department plan is not expected until early 1978.

## IV. CONCLUSION

The Tax Reform Act of 1976 significantly increased the tax burden imposed on non-resident U.S. citizens. Although the new provisions will generate added tax revenue, their impact on the employment practices of American firms operating in foreign countries remains to be seen. The fear that American business will be placed at a competitive disadvantage internationally has led Congress to think twice about these changes. Hopefully a hard look at the taxation of Americans working abroad will produce a solution which not only puts residents and non-residents on an equal footing but which does not handicap the position of the U.S. business interests overseas.

# Genèse et Motivations d'une Réforme Fiscale ~

## Le cas de la loi française portant imposition des plus-values

## Deuxième partie

par Jean-Loup Haÿ

### IV. LES POUVOIRS DU LEGISLATIF

Après avoir lentement cheminé de l'Exécutif officiellement le 20 avril 1976 est transformé, amendé, à bien des égards dénaturé puis voté finalement par le Parlement au cours de l'été de la même année.

La commission des finances de l'Assemblée nationale en est saisie en mai. Des débats préparatoires à la discussion en séance publique auxquels elle se livre alors, on peut retenir les préoccupations dont fait part son rapporteur, M. Papon: [24]

1. L'élargissement de l'assiette de l'impôt sur le revenu par la taxation de l'ensemble des plus-values n'aurait dû être envisagée qu'après un examen des aspects économique et sociologique du phénomène des plus-values ainsi que d'une étude systématique des conditions dans lesquelles elles se forment et se répartissent.

2. Il paraît difficile de respecter les principes de modération et de justice qui ont été retenus par le gouvernement si certaines taxations sont alignées sur les taux de l'impôt sur le revenu et si d'autres entrainent le recours à un barème forfaitaire.

3. Le souci d'unification fiscale se heurte, du fait de la généralisation, à la diversité des matières imposables.

Au cours de ses séances de travail, la commission des finances adopte un nombre important d'amendements présentés, pour la plupart, par des commissaires appartenant au groupe U.D.R., tels que MM. Papon, Bernard Marie et Marette. Les plus significatifs tendent:

- à prévoir le paiement fractionné ou différé pendant une période de cinq ans;
- à prévoir, au choix du contribuable, l'exonération de la première résidence principale ou de la première résidence secondaire;
- à limiter à dix ans la durée d'imposition des plus-values des valeurs mobilières à revenu variable;
- à supprimer l'exonération des obligations;
- à permettre les compensations entre plus-values et moins-values de toute nature;
- à prévoir l'instauration d'un système de "compte spécial d'investissement" soumis à une imposition globale;
- à soumettre à la taxation la pièce d'or française de vingt francs;
- à porter à deux ans la durée du court terme pour les immeubles et à un an pour les valeurs mobilières;
- enfin, à préciser que l'exonération des plus-values joue pour les immeubles à compter de la vingtième année et pour les terrains à compter de la trentième. [25]

Le projet gouvernemental a déjà subi une première dislocation. Pour les députés, les discussions commencement le 1er juin 1976 par la présentation du rapport de M. Papon. Ce dernier indique très clairement que les phénomènes de rejet que l'opinion a opposés au projet découlent de son caractère ambigu, de sa présentation artificielle, de ses conséquences économiques et de ses implications sociales.

"Le malentendu a subsité quand on a cru que ceux qui payaient déjà paieraient encore sans être sûr que ceux qui ne paient pas paieraient enfin". [26] Pour le dissiper, la commission des finances a eu pour souci, comme le rappelle ensuite son rapporteur:
(1) de tenir compte de la nature des enrichissements légitimes ou sans sause, ou des plus-values à court terme par rapport à celles à long terme (qui sont des gains en capital),
(2) de ne pas pénaliser le patrimoine en formation,
(3) de parvenir à une réelle adaptation des considérations fiscales, économiques et sociales et d'assurer une cohésion au texte du projet,
(4) de procéder à des choix guidés par la logique et susceptibles d'une présentation claire.

Le débat s'ouvre alors: il sera souvent houleux et difficile, mais aussi plein d'enseignements. Il convient ici d'en décrire quelques traits ou moments essentiels.

En premier lieu, à l'instar des citoyens qu'ils représentent, les parlementaires se passionnent véritablement pour un projet qui, en fait, ne concernera que peu de contribuables chaque année et rapportera vraisemblablement moins de 1 pour cent du Budget. Ce qui émeut les plus informés des français est la prise brutale de conscience qu'un changement se prépare qui laisse deviner un des aspects de la société de demain!

Au Palais Bourbon — siège de l'Assemblée nationale —, on mesure couramment l'importance d'un débat au fait qu'il remplit l'hémicycle ou les couloirs: le débat sur l'imposition des plus-values fait travées plaines. La presse y fait écho de diverses manières, bien que la quasi-totalité des quotidiens et hebdomadaires soit unanime à condamner le projet de loi. L'un d'eux propose d'abord à ses lecteurs de soutenir un contre-projet, puis les invite à signer une pétition visant à influencer ou à infléchir les orientations précisées par le Ministre des finances. [27] Un autre parle

24. Bulletin des Commissions de l'A.N. No. 8, Jeudi 20 mai 1976; Bulletin de l'A.N., Secrétariat général de l'A.N., 25 mai 1976, V° législature, Numéro 89, p. 22.
25. Bulletin de Commissions, No. 9, Séances du 25 et du 26 mai 1976; Bulletin de l'A.N., 8 juin 1976, No. 90, pp. 25-29.
26. J.O., Débats Parlementaires, A.N., No. 44 A.N., 2 juin 1976, p. 3566.
27. *La Vie Française - L'Opinion*, No. 18, Lundi 3 mai 1976, pp. 6-7 et No. 20, Lundi 17 mai, p. 17.

même "d'impôt idiot"![28] Les qualificatifs employés sont éloquents et montrent bien que les quelques organes de presse qui façonnent une frange d'opinion publique s'opposeront farouchement au projet, jusqu'à faire reculer le gouvernement: on parle tantôt d'imprévision ou de démagogie, tantôt de scandale ou de complications inutiles. Interrogé par le "Nouvel Economiste", P. Uri avait donné le ton dès avant le remodelage parlementaire en parlant d'un "projet passoire, injuste et nuisible".[29] En second lieu, certains amendements adoptés par les députés transforment radicalement la portée du projet sans pour autant en modifier la texture. On s'en rendra compte à la lecture du tableau II où figurent l'ensemble des scrutins relatifs aux amendments apportés au projet gouvernemental.

28. *Valeurs Actuelles*, Lundi 10 mai 1976, article de R. Bourgine, pp. 34-39.
29. *Le Nouvel Economiste*, No. 31, Lundi 17 mai 1976, interview recueillie par M. Chauvière, pp. 39-40.

## TABLEAU II

*Liste chronologique des scrutins portant sur les amendements déposés en séance lors des discussions sur le projet de généralisation de l'impôt sur les plus-values*
(Extraite du *Bulletin de l'Assemblée nationale*, Statistiques 1976, Numéro spécial, février 1977, annexe 4.)

| No du scrutin | Date de la séance | Page du compte rendu * | OBJET | RESULTATS Pour | Contre | Abst. |
|---|---|---|---|---|---|---|
| 325 | 1er juin | 3594 | Imposition des plus-values. — Question préalable de M. Ballanger. | 181 | 287 | 12 |
| 327 | 8 juin | 3858 | Imposition des plus-values. — Motion de renvoi en Commission de M. Bardol. | 185 | 271 | 21 |
| 328 | 8 juin | 3871 | Imposition des plus-values. — Impôt annuel sur les grosses fortunes détenues par les personnes physiques (article additionnel no. 7 R de M. Bonhomme). | 193 | 276 | 12 |
| 329 | 8 juin | 3872 | Imposition des plus-values. — Impôt annuel sur le capital des sociétés et les fortunes des personnes physiques (article additionnel no. 13 de M. Combrisson). | 182 | 284 | 11 |
| 330 | 8 juin | 3873 | Imposition des plus-values. — Impôt annuel sur les fortunes supérieures à 2 millions de francs détenues par les personnes physiques (article additionnel no. 83 de M. Duffaut). | 185 | 284 | 13 |
| 331 | 9 juin | 3923 | Imposition des plus-values. — Réintégration dans le bénéfice imposable d'un certain nombre de provisions (article additionnel no. 10 de M. Gosnat). | 78 | 292 | 101 |
| 332 | 9 juin | 3924 | Imposition des plus-values. — Réduction des facilités offertes aux entreprises par le régime actuel des amortissements (article additionel no. 15 de M. Bardol). | 179 | 296 | 1 |
| 333 | 9 juin | 3925 | Imposition des plus-values. — Dépôt par le Gouvernement, au cours de la prochaine session parlementaire, d'un projet de loi portant réforme de la fiscalité (article additionnel no. 14 de M. Combrisson). | 179 | 301 | 3 |
| 334 | 9 juin | 3926 | Imposition des plus-values. — Assimilation à un revenu des plus-values réalisées en moins d'un an, au lieu de deux ans (amendment no. 236 de M. Glon). | 68 | 199 | 186 |
| 335 | 9 juin | 3941 | Imposition des plus-values. — Révision du prix d'acquisition en fonction de l'évolution de l'indice moyen annuel des prix à la consommation, lorsque la cession intervient plus d'un an après l'acquisition (article additionnel no. 292 de M. Schloesing). | 73 | 155 | 188 |

* Le numéro de page indiqué dans cette colonne correspond au Journal Officiel, débats parlementaires, Assemblée nationale, année 1976.

| No du scrutin | Date de la séance | Page du compte rendu * | OBJET | RESULTATS Pour | Contre | Abst. |
|---|---|---|---|---|---|---|
| 336 | 10 juin | 3957 | Imposition des plus-values. — Cession d'immeubles achetés depuis plus de deux ans et moins de dix ans: cas où la preuve de l'intention non spéculative est réputée apportée (amendement no. 323 R du Gouvernement, modifié par les sous-amendments nos. 326, 327 et 328 de M. Mario Bénard). | 303 | 0 | 178 |
| 337 | 10 juin | 3983 | Imposition des plus-values. — Suppression de l'article 4 relatif au régime des plus-values réalisées en plus de dix ans (amendements no. 88 de M. Duffaut, no. 234 de M. Mesmin et no. 256 de M. Voisin). | 210 | 251 | 7 |
| 338 | 10 juin | 3984 | Imposition des plus-values. — Les plus-values réalisées en plus de dix ans sont réduites de 3,33% du prix d'acquisition par année de possession au-delà de la dixième (amendement no. 280 de M. Zeller). | 187 | 280 | 7 |
| 339 | 15 juin | 4113 | Imposition des plus-values. — Exonération de toute plus-value réalisée lors de la cession d'une habitation par foyer fiscal quand le prix de cette cession est inférieur à 150.000 francs par part de revenu (amendement no. 89 de M. Duffaut). | 191 | 269 | 20 |
| 340 | 15 juin | 4114 | Imposition des plus-values. — Exonération de toute plus-value réalisée lors de la cession d'une résidence principale quand le prix de cette cession n'excède pas 500.000 F., et décote graduée jusqu'à un million de francs (amendement no. 18 R de M. Bardol). | 182 | 285 | 13 |
| 341 | 15 juin | 4135 | Imposition des plus-values. — Exonération des plus-values réalisées lors de la cession d'une résidence principale ou secondaire, mais taxation de toute cession ultérieure, sauf de celle d'une résidence principale motivée par une meilleure utilisation familiale ou un changement de résidence (amendement no. 130 de la Commission des Finances, modifié par le sous-amendement no. 324 de M. Chauvet). | 53 | 240 | 189 |
| 342 | 15 juin | 4136 | Imposition des plus-values. — Suppression de l'exonération des obligations (amendement no. 135 de la Commission des Finances et no. 45 de M. Marie). | 162 | 77 | 200 |
| 343 | 16 juin | 4207 | Imposition des plus-values. — Exonération des biens fonciers à usage agricole dont le revenu cadastral révisé ne dépasse pas 3.840 F (amendement no. 22 de M. Pranchère). | 180 | 289 | 4 |
| 344 | 16 juin | 4208 | Imposition des plus-values. — Exonération des terrains agricoles lorsque le prix de vente ne dépasse pas le montant maximum fixé annuellement par la commission départementale des impôts (amendement no. 92 de M. Pierre Joxe). | 182 | 285 | 8 |
| 345 | 16 juin | 4209 | Imposition des plus-values. — L'exemption des cessions n'excédant pas 10.000 F dans l'année s'applique "sauf option contraire du contribuable" (amendement no. 142 de la Commission des Finances). | 215 | 216 | 3 |
| 346 | 16 juin | 4233 | Imposition des plus-values. — Imputation des moins-values, réalisées sur les éléments de patrimoine non exonérés, sur les plus-values de toute nature réalisées dans l'année ou durant les cinq années suivantes (amendements no. 144 R de la Commission des Finances et no. 51 R de M. Marie). | 144 | 308 | 19 |

* Le numéro de page indiqué dans cette colonne correspond au Journal Officiel, débats parlementaires, Assemblée nationale, année 1976.

| No du scrutin | Date de la séance | Page du compte rendu * | OBJET | RESULTATS Pour | Contre | Abst. |
|---|---|---|---|---|---|---|
| 347 | 16 juin | 4234 | Imposition des plus-values. — Imputation des moins-values sur les plus-values de même catégorie réalisées dans l'année ou durant les cinq années suivantes (amendement no. 95 - 2e R de M. Duffaut). | 243 | 190 | 27 |
| 348 | 16 juin | 4235 | Imposition des plus-values. — Plafonnement à 75.000 F de la moins-value imputable instituée en faveur des personnes spoliées outre-mer (sous-amendement no. 344 du Gouvernement à l'amendement no. 295 de M. Mario Bénard). | 254 | 220 | 5 |
| 349 | 16 juin | 4236 | Imposition des plus-values. — Imputation sur les plus-values de la moins-value constituée par la différence entre la valeur d'indemnisation reconnue par la loi aux personnes spoliées outre-mer et l'indemnité due ou perçue par eux (amendement no. 295 de M. Mario Bénard, complété par le sous-amendement no. 344 du Gouvernement). | 475 | 5 | 3 |
| 350 | 17 juin | 4287 | Imposition des plus-values. — Pour la détermination de la plus-value sur cession de valeurs mobilières, l'option exercée par le contribuable vaut pour l'ensemble du portefeuille acquis avant l'entrée en vigueur de la loi (sous-amendement no. 345 du Gouvernement à l'amendement no. 155 de la Commission des Finances). | 204 | 257 | 4 |
| 351 | 17 juin | 4288 | Imposition des plus-values. — Modalités de la détermination de la plus-value sur cession de valeurs mobilières (amendement no. 155 R de la Commission des Finances). | 286 | 181 | 9 |
| 352 | 17 juin | 4289 | Imposition des plus-values. — Possibilité, pour les personnes physiques et les clubs d'investissement, de constituer un compte spécial d'investissement soumis à un régime d'imposition globale (amendement no. 156 de la Commission des Finances, complété par les sous-amendements nos. 346 et 347 du Gouvernement et no. 343 de M. Mario Bénard). | 286 | 0 | 187 |
| 353 | 17 juin | 4319 | Imposition des plus-values. — La présente loi ne s'applique pas aux plus-values réalisées lors de la cession à des tiers des droits sociaux détenus, dans les conditions de l'article 160 du Code général des impôts, par les associés, actionnaires ou commanditaires (amendement no. 319 C de M. Chauvet). | 30 | 257 | 185 |
| 355 | 22 juin | 4470 | Imposition des plus-values. — Impôt spécial sur les profits spéculatifs et les enrichissements sans cause, dont les modalités seront proposées par le comité chargé d'étudier les interventions foncières des collectivités locales (article additionnel no. 249 R de M. Charles Bignon). | 207 | 250 | 22 |
| 356 | 23 juin | 4562 | Projet portant imposition des plus-values et création d'une taxe forfaitaire sur les métaux précieux, les bijoux, les objets d'art, de collection et d'antiquité (première lecture - ensemble). | 256 | 197 | 26 |
| 364 | 9 juillet | 5248 | Projet portant imposition des plus-values et création d'une taxe forfaitaire sur les métaux précieux, les bijoux, les objets d'art, de collection et d'antique (texte de la commission mixte paritaire). | 251 | 192 | 20 |

* Le numéro de page indiqué dans cette colonne correspond au Journal Officiel, débats parlementaires, Assemblée nationale, année 1976.

Ce sont en fait plus de cinq cents amendments qui sont déposés sur le bureau de l'Assemblée nationale et que le Ministre devra combattre. Avant le début des débats parlementaires, un "compromis" était passé entre J.-P. Fourcade et les représentants de la majorité. Les termes en sont très vite abandonnées et, les affrontements qui se produisent durant les premiers jours de la discussion entre le Ministre et le groupe de l'U.D.R., menacent un moment la cohésion de la majorité.

Pour éviter une aggravation de la situation déjà très tendue et surtout, pour ne pas risquer une dislocation de son partie — qui préluderait à une profonde crise entre l'Exécutif et le Législatif — J. Chirac, qui s'est jusque là contenté d'agir en vertu de sa qualité de Premier ministre, sans prendre position, intervient auprès des représentants du bureau parlementaire de l'U.D.R. pour les inciter à la détente.

De son coté, le gouvernement n'envisage pas avec satisfaction les propositions d'amendement faites par les parlementaires, d'autant plus qu'elles sont susceptibles de dénaturer complètement le projet initial. Il s'efforce alors de jouer un rôle plus actif dans la procédure, comme le lui permet l'article 45 alinéa 2 de la Constitution de 1958 qui prévoit que, si le *gouvernement déclare l'urgence*, le Premier ministre peut proposer la réunion de la Commission Mixte Paritaire chargée de proposer un texte sur les dispositions restant en discussion.

Le projet de loi (No. 370) ainsi modifié est adopté en première lecture le 23 juin 1976. Il est alors transmis au Sénat où le rapporteur de la commission des finances, Y. Coudé du Foresto, est appelé, le 6 juillet, à présenter aux sénateurs les conclusions établies par celle-ci, et cela, après l'intervention du rapporteur du Conseil Economique et Social. Ainsi, contraitement à la procédure suivie par l'Assemblée nationale, P. Uri est-il invité — par le Président A. Poher, conformément à l'article 69 de la Constitution interprétée de façon très libérale — à faire part de l'avis adopté par l'assemblée qui le mandate et à donner ultérieurement son point de vue sur tel amendement ou sur tel point précis de la discussion. [30] En quelques jours, les sénateurs se prononcent ensuite sur plus de cent soixante amendements.

Comme cela s'est produit devant le Conseil Economique et Social puis l'Assemblée nationale, certains amendements visent l'institution (par l'adoption d'articles additionnels) d'un impôt annuel et progressif sur le capital des sociétés et la fortune des personnes privées. Celui présenté par M. Caillavet n'étant pas soutenu, l'assemblée n'a même pas à en délibérer; les deux autres, proposés par MM. Lefort, Gaudon, Jargot et les membres du groupe communiste, sont finalement repoussés par les sénateurs, comme ils l'avaient été par la commission sénatoriale des finances et par le gouvernement. [31] Les arguments invoqués sont de deux sortes; les premiers ont trait à la forme: un contre-projet de réforme fiscale doit être étudié et préparé de manière approfondié; les seconds tiennent au fond: le moyen choisi par le gouvernement n'est pas celui de l'imposition du capital mais vise essentiellement à réduire l'importance de l'un des facteurs d'inégalité, à savoir l'existence et la réalisation de plus-values à l'occasion de la cession d'éléments d'actifs par des personnes physiques. [32]

Le 8 juillet, la Commission Mixte Paritaire est intallée, à la demande du Premier Ministre aux Présidents des deux assemblées. Par cette intervention certes conforme à la Constitution, le gouvernement démontre tout de même qu'il entend utiliser l'atout dont il dispose: une majorité à l'Assemblée nationale qui lui donne les moyens de subordonner le Sénat à cette dernière. Sur les 12 articles que comportait le projet, tous restent en discussion! En sept heures de travail, la Commission Mixte élabore un texte — auquel elle propose de donner un intitulé qui sera celui de la loi — qui est adopté par les députés, le 9 juiller, par 251 voix contre 192 et, par les sénateurs, le jour suivant, par 141 voix contre 107.

Par les nombreuses corrections et nuances que les parlementaires ont apportées au texte du projet qui leur était soumis, ils en ont atténué le caractère excessif; par les abattements et exonérations de toute nature qu'ils ont ajoutés, ils ont aussi remédié à certaines de ses insuffisances. Ce faisant, ils ont mieux adapté la nouvelle législation aux exigences sociales et aux contraintes nées du développement économique.

## V. CONCLUSION

Le nouveau régime d'imposition des plus-values résulte donc, de facto, d'une collaboration entre ceux qui en proposèrent les orientations et caractéristiques essentielles et les parlementaires dont la tâche principale fut de résoudre les nombreux problèmes pratiques nés de la poursuite d'objectifs très divers: *l'efficacité, la justice et la simplicité.*

Curieusement, c'est la recherche du *rendement* qui a le plus souvent été négligée, plus par les défenseurs de la réforme que par ceux qui s'y opposèrent en même temps qu'au projet de loi. Les premiers n'avaient sans doute pas un grand avantage à arguer du peu de recettes qu'il était raisonnable d'attendre de l'application de l'impôt sur les plus-values, mais ils auraient eu intérêt à souligner qu'on pouvait espérer en tirer un rendement indirect non négligeable. Les seconds trouvaient là un argument solide pour affirmer péremptoirement que la réforme devenait inutile si elle ne visait pas d'abord à procurer des ressources à l'Etat.

L'examen attentif des différents épisodes du processus d'élaboration du texte de loi montre à l'évidence que le Chef de l'Etat a voulu imposer un élément de la politique de changement qu'il conduit, tout en profitant d'un régime où la *prééminence du pouvoir présidentiel* a été instaurée par les Gaullistes. Même si l'U.D.R. avait inscrit à son programme le principe de taxation des plus-values, ses représentants au Parlement se sont d'abord opposé au projet d'une part, parce qu'il présentait des imperfections à leurs

30. Voir J.O., Sénat, séance du 6 juillet 1976, p. 2150.
31. Ibid, séance du 7 juillet, pp. 2191-2192.
32. Ce type d'argumentation sera d'ailleurs réutilisé par le Premier Ministre R. Barre en réponse à certaines propositions d'institution d'un impôt annuel sur le capital faites à l'Assemblée nationale au moment des débats relatifs à la contribution exceptionnelle pour venir en aide à l'agriculture touchée par la période de sécheresse de 1976.

yeux très graves mais aussi, d'autre part, parce qu'ils n'en étaient pas les initiateurs, ce qui traduisait bien leur puissance passée. Ils se rallièrent au projet proposé par la Commission Mixte Paritaire parce qu'ils s'y trouvaient quelque peu contraints, que de nombreuses améliorations avaient été apportées au texte et enfin, parce qu'ils ne pourraient être accusé d'avoir proposé une réforme assez peu populaire ni, surtout, d'avoir provoqué la dislocation de la majorité parlementaire et de la coalition gouvernementale qui lui est rattachée.

L'une et l'autre ont finalement vaincu sans se livrer à une lutte dont l'issue eut été irréversible. La première est restée unie, en partie parce qu'elle a réussi à faire admettre des amendements qui ont transformé radicalement le projet initial; la seconde a résisté en faisant abstraction des dissensions apparues entre les partis et en se rangeant à l'idée de réforme proposée par le Président de la République.

Il reste que celui-ci aura pris conscience de ce que le Parlement garde, en matière fiscale plus qu'en toute autre, son mot à dire et qu'il peut modifier un projet jusqu'à en faire *un simple aménagement technique* de la législation déjà en vigueur. De plus, "l'affaire de plus-values" aura profondément marqué les rapports entre le Président de la République et la majorité du fait que certains parlementaires ont eu l'impression d'être "pris au piège"; elle influencera aussi les relations qu'il aura avec les parlementaires de l'opposition du fait qu'ils ont refusé de voter un texte qui allait dans le sens d'un réformisme social qu'ils proposent eux-aussi.

L'impression d'ensemble qu'on en retire est que, pour les uns, comme pour un grand nombre de français, la réforme n'était *pas nécessaire*, tandis que pour d'autres, elle n'était *pas suffisante*.

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# Cumulative Index 1978 - No.1

# Experience with Urban Land Value Tax in Developing Countries[1]

by George E Lent

*Despite the superiority of land value taxes from the points of view of equity, allocative effects, and administrative efficiency, it is somewhat surprising to find that they are employed, in pure or mixed form, by very few developing countries. This can be explained in part by conditions of land tenure and occupancy, but also by historical circumstances and governmental inertia. Property taxes based on annual value were already well established by two of the major colonial powers — France and Great Britain — and these were generally transplanted to the colonies.* [2]

*While a number of British commonwealth countries have departed from this system, none of the French-speaking countries has done so.* [3] *A review of the conditions precedent to the introduction of land value taxes and problems of their implementation may help explain their limited use. Attention will then be given to the experience of developing countries in maintaining land value taxes as an instrument of urban government finance.*

*First, however, it will be useful to review the trend of urban land tax legislation in developing countries since the turn of the century.*

TABLE OF CONTENTS



## I. A CONSPECTUS

### 1. The record of adoptions

It is significant that urban land value taxes have been successfully introduced only at the early stages of a country's development. By the turn of the century Australia, New Zealand, the Union of South Africa, and Canada's western provinces had enacted taxes on unimproved land value. [4] By 1914, the concept of separate taxes on land value began to spread from South Africa to the three territories of the Federation of Rhodesia and Nyassaland (now Rhodesia, Zambia, and Malawi) and in 1921 to Kenya, when Nairobi adopted rates limited to land value. Other municipal councils of Kenya and Uganda followed, but this system was not adopted by Tanzania (Dar es Salaam) until 1952.

Thailand's local development tax was introduced in 1938; it is a tax on land value levied for the support of municipalities, sanitation districts, and provincial governments. In 1965 its administration was transferred from the Ministry of Finance to the local governments, under the supervision of the Ministry of Interior. [5] The origin of China's land value tax is found in its Land Law of 1930. While it was adopted by four large cities of China before 1937, it was not promulgated in the Republic of China (Taiwan) until after it reverted to Chinese rule, in 1946, and it was not until the enactment of the Statute for Equalization of Land Rights, in 1954, that it was implemented in its present form. [6]

More recently, Barbados, Jamaica, and Trinidad and Tobago have replaced their traditional property taxes by taxes on unimproved land values. In December 1956 Jamaica approved a Land Valuation Law which provided for the revaluation of all land; by 1962, however,

1. Paper presented at a symposium to commemorate the Centennial of Henry George's writing of *Progress and Proverty*, Taipei, October 3-5, 1977.
2. This historical background is summarized in George E. Lent, "The Urban Property Tax in Developing Countries", *Finanzarchiv*, Band 33, Heft 1 (1974), pp. 45-72.
3. Land value taxes were introduced independently by the Republic of China, Iraq, and Thailand.
4. For a good survey, see Harry Gunnison Brown, *et. al.*, editors, *Land Value Taxation around the World* (New York: Robert Schalkenbach Foundation, Inc., 1955).
5. It should be noted that Thailand also imposes a "house and rent" tax on owners of houses and buildings rented or used for commercial purposes. It is based on the annual value of the property or actual rents received and is therefore more akin to an income tax.
6. For an excellent account of Taiwan's land tax system and its origins, see Wei-hsin King, "Land Taxes of the Republic of China (Taiwan)", in John Wong, editor, *The Cities of Asia: A Study of Urban Solutions and Urban Finance* (Singapore, 1976), pp. 379-399.

only six of Jamaica's 14 parishes has been brought under the new system when the program came virtually to a halt. It was not revived until the change in Government in 1972, and by 1974 the land valuation was completed — 18 years from the enactment of the law. [7] Barbados replaced its annual value tax by the Land Valuation Act, 1969; following enactment of the Land Tax Act, 1973, the new taxes were first levied for the fiscal year 1972/73. Trinidad and Tobago proceeded along similar lines under the Valuation of Land Act, 1969, and enacted its modified land value tax in 1973.

Australia introduced its land tax system in Papua New Guinea with the enactment of the Local Government (Rates and Taxes) Ordinance, 1970. The taxes were first levied in March 1972 and by August 1973 they were in effect in eight councils.

Unimproved land value taxes are also in effect in Iraq, where they are limited to cities. Many other developing countries levy special rates on unimproved or vacant land in urban areas, including Colombia, Greece, Ivory Coast, Paraguay, Peru, Senegal, Syria, and Turkey.

## 2. Trends in industrial countries

As was indicated above, no industrial nation has established urban land value taxes, despite early efforts in the United States (e.g., Pittsburgh and Scranton) and in Great Britain. Germany's early attempts to tax land took the form of taxes on increments in value. [8] Nor have Canada's original municipal site value taxes survived. In 1914 many cities and towns in Alberta and British Columbia (including Edmonton, Vancouver, and Victoria) taxed only unimproved site values; since then, all municipalities in British Columbia have included 75 percent of the value of buildings, for school rates, and Alberta's cities have included 60 percent of the value of improvements. [9]

Because of local options and differing state laws, there is a mixed situation in Australia, New Zealand, and the Union of South Africa. Local authorities in both Australia and New Zealand levy rates on either unimproved land value, total capital value, or annual value. [10] Since 1896, when New Zealand's legislation provided for a local option, [11] there has been a steady shift from capital value and annual value rating systems for *general rates* with the result that by 1968 77.7 percent of all territorial authorities had declared for unimproved value. [12] Nevertheless, if revenue from special and separate rates is included, the preference is less impressive — 53.5 percent was derived in 1963/64 from unimproved value as against 44.2 percent from capital value. The situation in Australia is comprable; [13] approximately two thirds of the local authorities use unimproved site value for general rating but employ annual rating for special rating purposes except in Queensland and Canberra, the capital territory. About one half of all local authorities in the Union of South Africa favor capital value rating; pure site value is the least popular system and appears to be important only in the Transvaal where Johannesburg has been a notable exponent. [14] The distinguishing feature of South Africa's rating system is the wide use of differential rates on land and improvements, those on land being a multiple of the rate on improvements.

## 3. Recent trends in developing countries

The site value taxes of Barbados, Jamaica, Papua New Guinea, and Trinidad and Tobago are relatively new, and further changes would be premature. Although Jamaica's earlier test of the law was favorable, only rural communities were affected and the rates generally applicable were low. [15] The recent measure (1972) covered the large urban areas and can be expected to have a greater impact.

Notable changes have taken place in east and central Africa where the trend toward nationalization has undermined taxes based on land value. In 1952, Tanzania replaced the annual value rate base by site value, and site-value taxes were levied on long-term occupancies in a majority of the towns at rates ranging from 4 to 6 percent; in addition, land rent was normally fixed at 5 percent. As changes in the land tenure system impaired the value of freehold land and long-term leaseholds, the site value basis became increasingly untenable and the Government in 1970 decided to replace it by a tax on the capital value of buildings. This proposal was subsequently dropped, and effective July 1, 1974, the Land

7. A vivid account of this experience is presented by O. St. Clare Risden, "A History of Jamaica's Experience with Land Taxation based on the Site Value System", TRED Conference, Cambridge, Massachusetts, October 22-24, 1976. On the earlier phase, see Daniel M. Holland, "A Study of Land Taxation in Jamaica", in Arthur P. Becker, editor, *Land and Building Taxes: Their Effect on Economic Development* (Madison, Wisconsin, 1969).

8. For a brief account, see George E. Lent, "The taxation of Land Value", IMF *Staff Papers,* March, 1967.

9. F.H. Finnis, "Site Valuation and Local Government", *Canadian Tax Journal,* XI No. 2 (March-April, 1963), p. 119.

10. For an excellent description and appraisal, see A.M. Woodruff and L.L. Ecker-Racz, "Property Taxes on Land Use Patterns in Australia and New Zealand". The Tax Executive, XVIII, No. 1 (October, 1965), pp. 16-63. Reprinted in Arthur P. Becker, editor, *Land and Building Taxes: Their Effect on Economic Development.*

11. With the abolition of the system of Provincial Government in 1876, the Rating Act provided for only annual value. In 1882 this was amended to require capital value except for boroughs established under the Municipal Corporations Act. It was not until passage of the Rating on Unimproved Value Act of 1896 that unimproved value was recognized but, unlike the other systems, this could be adopted only by a poll of rate payers. Valuation Department, New Zealand, *Local Rating in New Zealand, A Study of its Development.* Research Paper 663, May 1966.

12. J. Bruce Brown, "Updating New Zealand Land Tax Systems", Annual Conference, International Association of Assessing Officers, Boston, Massachusetts, September 19-22, 1971 (mimeographed).

13. The Australian federal land tax was originally levied in 1910 on unimproved land value at highly graduated rates. It was relinquished to the state in 1952.

14. J.W. Cowden, *Holmes' Local Government Finance in South Africa* (Durban: Butterworths, 1969), pp. 78-83.

15. Holland, "A Study of Land Taxation in Jamaica", pp. 273 277.

(Rent and Service Charge) Act abolished site rates as well as the municipal and urban house taxes and levied a "land rent and service charge" based on the value of land. The erosion of property rights in land, however, has increasingly posed problems of determining the value of land and this solution may not prove to be viable.

Zambia's differential property tax, once regarded as one of the best administered in tropical Africa, has also succumbed to changes in the Government's land tenure policy. In June 1975 the President, in a measure designed to halt all speculation in land, declared that as of that date land had no value. The Land (Conversion of Titles) Act, October 1975 requires that the value of property sold shall be limited to the value of improvements; sales of real property require the approval of the Commissioner of Land, who is advised by a Lands Advisory Committee. As a result of these measures the entire system of rating has been limited to improvements.

In Asia, land value taxes have survived in the Republic of China and Thailand. It should be noted, however, that on January 1, 1968 the Republic of China superimposed a "house tax" on its land value tax. Unlike the land value tax, it is administered exclusively for local revenue purposes. In 1976 Thailand prepared legislation for a property tax on land and improvements that would replace its local development tax on land, to be administered by the Revenue Department, Finance Ministry. But following the change in Government in October 1976 this plan was laid aside.

In summary, urban land value taxes (including differential rating systems) remain in effect in relatively few developing countries: in Africa — only in the cities of Kenya, Malawi, Rhodesia, and Uganda; in the Caribbean — Barbados, Jamaica, and Trinidad and Tobago; in Asia — the Republic of China, Iraq, and Thailand; and also in Papua New Guinea. Although many developing countries have separate land value taxes on urban vacant sites and in agricultural areas, a recent survey of 58 representative developing countries disclosed that the above eleven countries with urban site value taxes (including those with differential rates on land and improvements) were in a small minority. [16] Most of the urban property taxes of the other countries (24) are based on annual value; these are followed in importance by those with capital value. A few countries limit their urban property taxes to the value of buildings.

## II. PROBLEMS OF INTRODUCING URBAN LAND TAXES

There are many obstacles to the introduction of land value taxes, most of which are common to the enactment of other property tax systems as well. An important prerequisite is a system of private rights in land, whether freehold or leasehold; this implies also a delineation of property boundaries and land registration. Once plots or tracts of land are identified there remains the problem of establishing values for rating purposes. Collection and enforcement are not considered here.

### 1. Conditions of land tenure

The opening of new territories under a system of land grants or preemptive claims to land facilitated the establishment of land value taxes in Australia, New Zealand, and Western Canada. Indeed, the territorial land taxes in both New Zealand and Australia were graduated with the size of holdings for the purpose of breaking up the vast landed estates then being formed. In the speculative fervor of the times it was an easy step to the adoption of site value taxes in the towns and cities that were mushrooming. Publication of *Progress and Poverty* undoubtedly influenced popular acceptance of this form of tax, although it would be difficult to identify the principal motivating factors. [17] According to Haig, the professional real estate interests in Western Canada supported the taxation of unimproved land value, in the belief that the rates in effect stimulated building without interfering with land speculation. [18] The landowners were primarily speculators whose chief interest was attracting new settlers.

A different situation prevailed in the settled areas of tropical Africa that were colonized by Europe. West African cities are mostly indigenous in origin. They developed without the full benefit of European concepts of private property ownership and land registry; property boundaries were confused and titles to urban land obscure and uncertain. [19] As a result, property taxes based on the value of land never developed in West Africa except for vacant land in some states. Rental value is the rule not only in French speaking but also in English speaking West African counties. In a number of countries, however, such as Ghana, Liberia, and most of Nigeria outside of the more developed southern states, property taxes are based on the value of buildings.

This situation is well exemplified by the experience of Ghana when in 1961 new legislation replaced conflicting systems of property tax on improvements. This step followed the recommendation of an Australian authority who examined the alternatives and concluded that the confused state of property ownership, ill defined property boundaries, and lack of a real estate market made a tax based on the reproduction cost of buildings, less depreciation, the most feasible approach. [20] Liberia's urban property tax has also been effectively limited to the value of buildings plus a fixed amount per unit area of land. In early 1973 work was started by UNDP experts on a program for the survey of land boundaries and registration of titles, parallel with a project to improve the fiscal cadaster with the objective of incorporating the

16. Lent, "The Urban Property Tax in Developing Countries", pp. 68-72.
17. See Getta Sheftel, *The Taxation of Land Value; A Study of Certain Discriminatory Taxes on Land* (Boston and New York, 1916), *passim*.
18. Robert Murray Haig, *The Exemption of Improvements from Taxation in Canada and the United States: A Report Prepared for the Committee on Taxation of the City of New York* (New York, 1915), pp. 274-277.
19. See John F. Due, *Taxation and Economic Development in Tropical Africa* (Cambridge, Massachusetts, 1963), pp. 102-109.
20. J.F.N. Murray, *Report on Valuation and Rating in Ghana* (United Nations Technical Assistance Program, 1958).

value of land in the urban property tax base. By the end of 1976, progress had been made only in Monrovia and the program came virtually to an end because of local resistance and political obstacles. The value of land has remained outside the fiscal cadaster. The outcome would appear to justify the observation made in an earlier report on Liberia's tax structure that "... this form of taxation (property tax) seems to be involved with the social and political character of the country, and we have not been in Liberia long enough to explore the problem to the depth that it would require if definitive recommendations were made." [21]

By contrast, as we have seen, the conditions for introducing land value taxes in the cities of east and central Africa were more favorable. This was made possible by a more complete system of land registry and better defined property rights for urban areas. There was, however, relatively little freehold property and most land was held under long-term leaseholds, usually for 99 years. So long as these leaseholds were freely transferable no special valuation problems arose. In general, land taxes are limited to leaseholds of more than five years.

The effect of rights in land occupancy on the viability of site value taxation is well illustrated by the record in Tanzania. The site value tax introduced in 1952 in the larger cities was limited to former freehold land (converted to government leaseholds) and land under long-term rights of occupancy — more than five years; leaseholds of under five years and land held under customary tenure were subject only to house tax. By 1970, important changes were made in the land tenure system. Government leases were converted into rights of occupancy; these were liable to land rent at standard rates (5 percent of value) which could be revised at not less than five-year periods, and transfers of rights of occupancy were made subject to official approval. Rights in land became so restricted and uncertain that they could not command a value in the market. As was indicated above, the tax on site value as well as the urban house tax were replaced in July 1, 1974 by a land rent and service charge.

The differential rating system in Zambia met a similar fate with the President's declaration in 1975 that land no longer possessed value.

## 2. The fiscal cadaster

Preparation of a fiscal cadaster is a time consuming and costly undertaking for which most less developed countries are not adequately prepared. The difficulties are compounded when a shift is made from an annual value or house tax system where there is minimal reliance on the accuracy of land boundaries and registration of property. But even a conversion from capital value taxes to site value taxes, as in Jamaica, presents serious problems of identifying and mapping property.

### a. *Experience in the Caribbean*

The major steps involved in the preparation of a cadaster consist of (1) mapping and editing; (2) referencing of land ownership; (3) market analysis; and (4) valuation. A brief review of the experience in introducing site value taxes in the Caribbean countries can do little more than suggest the magnitude of the problems involved. Each country had the benefit of a property tax expert supplied by the United Nations, John M. Copes, who served as advisor or administrator in Barbados, Jamaica, and Trinidad and Tobago.

Barbados' land tax program originated in 1963 with a report by the United Nations advisor who recommended that its annual value tax be replaced by a tax based on land value. After study and analysis a Land Valuation Division was established in 1969 with a staff of 42 persons. In addition to the Commissioner, Deputy Commissioner, and two supervising valuers, it included 10 valuers and 10 assistant valuers. [22] Field work on the cadaster started in February 1971. Mapping was handicapped by the lack of large scale maps, and this deficiency was met by aerial survey maps. Each parcel of land — 48,600 in all — was identified, described and valued, and the owners' names and addresses were recorded by early 1973. The tax became effective in 1973 — five and a half years from the initiation of the project and four years from the establishment of the Land Valuation Division.

The history of Trinidad and Tobago's land tax paralleled that of Barbados. The initial planning also began in 1963 with a study of the problems by the United Nations Advisor. A committee was then set up to advise on the establishment of a valuation department, which was authorized by the Valuation of Land Act, 1969. Following a period of training a staff of more than 100, field work began early in 1971 and the cadaster was substantially completed by March 1973 — about 10 years from the inception of the project and over four years from its legislative approval. Unlike the situation in Barbados, Ward Sheets provided an adequate working basis for the mapping and referencing of properties, and aerial surveys were not required. The size of the staff was more than double that of Barbados' and even larger than that in Jamaica.

Earlier attempts to implement a site value tax in Jamaica, in 1949 and 1951, were aborted, but work began on the preparation of large scale maps of the towns. It was not until 1956 that the Government introduced the Land Valuation Law, which was proclaimed in January 1957. A staff of about 80 was engaged and trained, and field work began in June 1957. By the end of four years over 171,000 parcels had been mapped and valued in predominantly rural areas by a nucleus of three professional valuers and 28 persons trained in valuation techniques supported by field assistants. [23] As we have seen, the program was suspended in 1962 before it reached the principal metropolitan area, and was not resumed

21. Carl S. Shoup, *et. al.*, *The Tax System of Liberia* (New York, Columbia University Press, 1970), p. 95.
22. See Claire Doblin, "Land Valuation and Land Taxation — UN Experience", United Nations Inter-Regional Seminar on Cadastral Surveying and Urban Mapping, Berlin (West), June 24-July 5, 1974.
23. John M. Copes, "The Move Towards Site Values as a Basis for Rates and Taxes in the Commonwealth Caribbean". Third Annual Conference of the Caribbean Organization of Tax Administrators, Antigua, September 11-15, 1972 (mimeographed).

until 1972. The staff was then enlarged to 150 and work in the rural areas was completed; in 1974 a final push was made to map and assess Kingston and St. Andrew parishes which covered more than half the total real estate value in Jamaica. [24]

Experience in these countries illustrates the major problems encountered in the introduction of property taxes based on land value. While all these programs were successfully completed, various obstacles contributed to long delays and expense.

*b. Mapping and referencing*

A major handicap was the lack of large-scale maps for the plotting and referencing of parcels that needed to be identified and valued. This deficiency was met by the use of aerial mapping, especially for rural areas. In the process, in Jamaica, thousands of parcels were discovered that previously had escaped the tax rolls under its capital value tax. It was also found in Jamaica that registered land titles existed for less than half the parcels of land in the rural areas; in the cities, however, the situation was much better because of the greater frequency of land sales and legal requirements for mortgages. A system of land taxation based on legal titles to land, while useful, imposes impossible standards of accuracy that would unduly forestall its implementation. It was decided in all three countries that a fiscal rather than a legal cadaster was sufficient for the purpose, and that in the absence of legal title anyone occupying the land would be chargeable for the tax.

In contrast to a land tax system based on taxes *in rem*, a tax *in personem* based on the aggregate value of properties under single ownership poses considerable problems of verifying land ownership. This is a common situation in Latin America, where wealth taxes are favored. In Nicaragua, for example, special measures had to be taken to reference the land maps by title to land. Because of the widespread system of tenancy and the lack of an adequate land registration system the Cartographic Agency gave wide publicity to the project, inviting the real owners to identify their property and present evidence of title. [25]

*c. Valuation procedures*

One of the great advantages claimed for site value taxes is the comparative simplicity of valuing land by mass valuation procedures, as against the additional valuation of improvements to land entailed by a capital value tax. [26] It is possible on the basis of records of sales to establish bench mark values for land in different sections of the urban areas or blocks of land and to measure variations of the value of different locations within the block or area by the use of well established formulae or gradients. The computer has proved to be an indispensable tool for the conduct of such mass valuations, and it is employed in a number of developing countries.

Establishing the value of urban land is a function of market analysis. Basic data may be derived from the records of the land registration office, announced prices of lots in real estate developments, valuations for mortgage loans, and other sources. In a rapidly developing city the frequency of sales of vacant land is usually sufficient for the purpose. In older established areas, however, transactions usually involve buildings as well and it is necessary to use the residual method of deducting the estimated value of the improvements; in cases where buildings are torn down and replaced, the cost of wrecking may be added as a measure of the site value.

One indication of the success of the valuation operation is the number of complaints received. Objections to assessments in Barbados were made by only 2.3 percent of the roll despite an average doubling of property taxes. [27] By contrast, the first phase of Jamaica's valuation was met by objections from about 11 percent; the objection rate of the second phase was about 8 percent. [28] Jamaica's less satisfactory experience is partly attributed to its generally higher rates of tax which are graduated with the value of each parcel of land.

Any major revaluation of property, whether of improved or unimproved land values, is bound to encounter objections. While valuation errors inevitably creep in, the radical increases in assessed values that result from a shift from either an annual value or a capital value system to a site value system yielding the same revenue are unsettling. Grounds for complaint are compounded when properties have not been reappraised for many years, as in Jamaica. The problem stems in part from the standards of valuation that guide the project. If land is to be valued at its "highest and best" use, hardships inevitably arise for those owning farmland, residential, and resort property that is ripe for development. This apparently was at the heart of the problem in Jamaica, which was obliged to provide relief from taxes on many who experienced hardships of this sort. This took the form of a reduction of taxes — up to 75 percent for agricultural land and 25 percent for hotel land — rather than a reduction in the assessed value of the land.

## III. MAINTENANCE OF LAND VALUE TAXES

Once land values are established, governments are confronted with the task of maintaining land taxes as a source of revenue to meet their growing revenue needs. It is of interest to know what the record of land tax revenue is, what measures are taken to keep the cadaster current, and what problems of discrimination arise.

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24. Risden, "A History of Jamaica's Experience with Land Taxation. . .".

25. Delegation of Nicaragua, "The Inventory of Real Property: Its Conservation and Maintenance". Inter-American Center of Tax Administrators, V Technical Seminar, Panama, 1971 (mimeographed).

26. Studies made in the 1960s of one local authority area in New Zealand showed the average cost of valuing land to be $NZ 0.60 per parcel as against $NZ 2.60 for annual value assessments and $NZ 4.00 for capital value assessment, Brown, "The Incidence of Property Taxes. . .", p. 251.

27. Doblin, "Land Valuation and Land Taxation", p. 18.

28. Risden, "A History of Jamaica's Experience with Land Taxation. . .", p. 18.

## 1. Revenue importance

Urban land taxes do not play an important role in the national finances of developing countries; property taxes in general, however, sometimes contribute substantially to the financing of municipal budgets. [29] This may be seen especially in Kenya where land rates account for over 40 percent of Nairobi's revenue and about 30 percent of Mombasa's. The differential rates in Zambia have accounted for over 70 percent of the revenue of the three city councils (Lusaka, Ndola, and Kitwe) and about 55 percent of that of the municipal councils. Malawi's differential rates amount to about 56 percent of the town councils' revenue (1969/70). In Thailand, however, the Land Development Tax is important only in rural areas (sanitation districts and Changvat Administrative Organizations) and in 1974 contributed only about 5 percent of municipal revenue, including that of the Bangkok metropolitan area. This low yield may be explained partly by underassessments and partly by the generous exemptions provided homeowners and owner/cultivators of farms. Papua New Guinea's land rates account for only 10 percent of the town councils' revenue (1974/75).

The Republic of China's land taxes, including the land value tax and the land value increment tax, are shared by the provincial (Taiwan) and local governments, with 70 percent of the receipts in municipalities (such as Taipei) going to the municipality and 80 percent in other local governments returned to them. In 1975, however, land value tax revenue represented only 1.5 percent of the tax revenue of all levels of government and in 1971 only 7.4 percent of Taipei's receipts. [30]

In the other countries for which information is available, the national government levies the tax on both urban and rural land and the revenue is not used to finance municipalities directly. As expected, the land tax revenue contributes only a small proportion of the national revenue: Barbados, 4 percent (1974/75); and Trinidad and Tobago, about 5 percent (1974, 1975).

## 2. Elasticity of revenue

Land tax revenue is relatively inelastic because the ratable base tends to be fixed; growing revenue requirements usually are met largely by rate increases rather than by frequent revaluation of land to reflect rising values. The assessment cycle is typically five years but it is not uncommon to postpone action. Although the record for property taxes based on annual value or improved land value is not impressive, they have an advantage in catching annual increments in the value of new buildings, if not land, and the built-in growth is greater than that of site value taxes.

Many examples could be cited of the lag of land assessments behind land values and the expediency of rate changes. Mombasa, the second city of Kenya, is a classic example. Land has not been reassessed since 1959, despite a five-year revaluation provision in the law, with the result that the ratable value of land increased by only 16 percent between 1960 and 1976 — an average annual increment of 1 percent. [31] To compensate for lagging cadastral values, nominal rates were raised from 3.0 percent in 1960 to 5.5 percent in 1975, and land revenues about doubled. Nairobi has been more efficient in this respect; between 1968 and 1976, for example, ratable values were raised by 30 percent — an average annual increase of about 3.3 percent. Even so, Nairobi's tax rates have been more than doubled, from 2.75 percent in 1968 to 6.75 percent in 1976, principally because ratable values remained virtually unchanged since the 1971 revaluation.

Although Zambia's tax on land was supplemented by a low-rate tax on improvements, the growth of municipal revenues is also attributable largely to increases in rates. Between 1964 and 1974, property tax revenue of the Copperbelt Urban Authorities rose fourfold, from 1,448,000 kwachas to 5,816,000 kwachas. During this period, two of the principal cities, Ndola and Kitwe, increased their land rates, from 4.3 percent to 5.5 percent and 4.2 percent to 6.7 percent, respectively, but they almost doubled their rates on improvements, from 0.8 percent to 1.5 percent, and from 0.96 percent to 1.7 percent, respectively. Assessed values of improvements, however, would also appear to have greatly increased but no information is available. Despite the higher rate on land it is likely that the revenue attributable to it is not much if any more than that on improvements because of their higher valuation. Steady increments in the value of the improvements probably contributed somewhat to the elasticity as compared with the lag in revaluations under a five- to ten-year cycle. [32]

Papua New Guinea planned a general reassessment beginning in 1977 but because of the repatriation of Australians and depressed economic conditions it is not expected to produce much if any increase in valuations. Meanwhile, as the land tax system became established, rates have been raised. Port Moresby, for example, has increased its rate from 1.25 percent to 2.25 percent.

With the introduction of Taiwan's land value tax in 1950, land values were based on transfer prices previously assessed by the Japanese authorities and adjusted for prices increases. [33] It was not until 1954 that valuations were determined in accordance with the Land Law, as implemented by the Land Rights Equalization Statute of 1954. Following Dr. Sun's principles, this prescribed

29. No information is available for Iraq, Rhodesia, or Uganda.
30. These data include only the urban land value tax. Inclusion of other taxes on urban and rural land and improvements would raise the total ratio to 9.4 percent; rural land tax, 2.2 percent; land value increment tax, 2.7 percent; house tax, 3.0 percent. Data prepared by the Ministry of Finance. For Taipei see Ministry of Finance, Department of Statistics, *Yearbook of Financial Statistics of the Republic of China*, 1971, p. 60.
31. Land values were depressed following independence because of the exodus of expatriates and general uncertainty over government policies.
32. Lusaka, not covered by these data, was on a three-year cycle.
33. The following account is based in part on W.S. King, "Land Taxes of the Republic of China", Bank of China, *Economic Review*, May-June 1969, July-August 1969; George E. Lent, "Taiwan's Land Tax Policy", *Bulletin for International Fiscal Documentation*, July 1977; Yearbook of Financial Statistics of the Republic of China, 1972; and other data supplied by the Ministry of Finance.

values that were to remain fixed indefinitely and provide the basis for Government recapture of any increments in value. For a decade, land tax revenue remained virtually constant in the face of rapidly rising urban land prices that accompanied population growth and economic expansion. By 1964 the necessity for adjusting assessments to market values was recognized, and the law was amended to provide for biennial reassessment when land prices rose by 50 percent or more. Reassessment followed. Further revaluation was not made until 1968; including a 25 percent increase in area covered, the land value base was enhanced by 164 percent. Despite soaring land values, no further assessment was made until 1975; during this period, 1969-1975, land tax revenue increased even by less than the increase in land area covered — 30 percent as against 45 percent. The extent of the lag in cadastral values behind market values is indicated by the 150 percent increase in assessed values that marked the 1975 revaluation. Recent changes in the law call for reassessment every three years.

### 3. Assessment problems

Although it is generally agreed that land can be assessed more efficiently than improvements to land, [34] developing countries have been confronted by a serious shortage of valuers. In Nairobi and Mombasa — both of which undertake their own valuations — as well as in the central office of the Commissioner of Lands, there exist numerous vacancies for valuers. Zambia also experienced an increasingly serious shortage of assessors after 1968 when the expatriates charged with this task began to withdraw. The training of Zambians met with little success. Hopes were then set on the establishment of a training program in the School for Environmental Studies. Other developing countries have also suffered from the lack of trained valuers.

The revenue elasticity of land value taxes would be greatly improved if it were feasible to shorten the appraisal cycle. In the past, Lusaka, Zambia, and Nairobi, Kenya were on a three-year cycle, although the law called for revaluations every five years. The dynamic role that can be played by site value taxes is exemplified by Johannesburg, South Africa, where revaluations are made on a three-year cycle.

The possibilities for improving valuation procedures are illustrated by Taiwan's experience. Although the land value law is based on the principle of self-assessment, in practice, property owners accept official valuations within a range of 20 percent. For purposes of the land value increment tax, however, the Land Administration undertakes yearly reappraisals which serve as the basis for measuring the gain on sale of land. It would therefore appear to be a logical step to revise land value tax assessments yearly. Although the burden placed on the valuers would be increased, the job is facilitated by computers and the improved elasticity of revenue would repay many times any additional cost involved.

### 4. Pressures for reform

The inelasticity of site value tax revenue and other considerations have led a number of countries to explore alternative property tax approaches to meet expanding budget requirements. We have noted developments in both Tanzania and Zambia where fundamental changes in land tenure rights have dictated shifts in land tax policy. Tanzania has merged its property tax with its land rental charge, but this approach would not appear to hold promise for improving land revenue because the absence of a market for land virtually eliminates any objective basis for establishing future land values. [35] Zambia has turned to the value of improvements for its property tax base; while valuations may reflect land values as well, unless the official decree abolishing land values is reversed, site value cannot be expected to play an important part in future property taxes.

China's basic Land Law of 1930 provided for a tax on improvements, exclusively for local government purposes. Such a tax, known as the house tax, was enacted in 1967 and was first effective January 1, 1968. House tax revenue rose sharply; by 1971 it overtook the land value tax in revenue importance and by 1976 it equalled the combined revenue from urban land value tax and the rural land tax. It is ironical that Taiwan's tax on improvements to land has greatly surpassed in revenue importance the tax on site value that has been an integral part of China's program for equalization of land rights.

More recently, Kenya has been giving serious consideration to supplementing the site value tax of its principal cities with a tax on improvements. It is believed that Nairobi's land value tax rate of 6.75 percent has reached its tolerable limit and that it must look to alternative sources of additional revenue.

In 1976, Thailand also resolved to reform its land development tax system and drafted new legislation based on improved land value. With the change in Government in October 1976, however, this proposal was withdrawn and plans for a new property tax were indefinitely deferred. [36] As was noted above, Thailand's land tax never was an important revenue producer largely because of underassessments and extensive tax concessions. [37] In 1974 it yielded only 330.0 million baht (US$ 16.5 million) in the entire country of which only 47.3 million baht (US$ 2.4 million) was realized by municipalities. One of the objectives of the land tax reform was to increase revenue sufficiently to redistribute municipal receipts to underdeveloped areas of the country.

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34. J.R. Hicks argues that "there is no means whereby site values can be satisfactorily derived from the prices paid for land "plus buildings", "Unimproved Value Rating — The case of East Africa", in *Essays in World Economics* (London, 1959) p. 241. This statement is disproved by experience throughout the world and begs the question of how capital values can be determined without arriving at a value for the land occupied by the improvement.

35. It is significant that in 1970 Tanzania's Government had decided to levy a rate on the capital value of buildings in addition to land rent, and an expatriate firm was hired to undertake the valuation because of the shortage of local valuers. This work was suspended with the land rent decision.

36. The Government is re-examining the most appropriate base for a property tax although there are no plans for its enactment.

37. In addition to substantial concessions to owners of rural land who till their farms, the law exempts urban property chargeable to the house and rent tax and exempts owner-occupied residents.

3. *Import prohibition and licensing*

In order to conserve scarce foreign exchange for capital formation and development a number of additions have been made to the list of prohibited imports including: beer bottles, spa waters and all cars over 2500 cc engine capacity. Cars between 2000 cc and 2500 cc will now attract 150 percent duty as well as being placed under licence along with cars below this capacity. Cars of an engine capacity not exceeding 1800 cc will now attract duty at 25 percent and cars between 1800 and 2000 cc at 40 percent. Other items added to those requiring an import licence include common salt, carpets, furniture, matches and canned beer and soft drinks.

As fas as tax policy is concerned the following points should be noted:

(i) Dividends: During the 1977-78 financial year distributions of dividends will remain restricted to 30 percent of pre-tax profits.

(ii) Scrip issue and revaluation of assets: Some companies have tried to circumvent the current restriction on dividends by increasing their paid-up share capital through bonus issues. In some cases they have achieved this purpose through the revaluation of assets. Government has now decided that any increase arising from revaluation of assets shall be placed in a special "Asset Revaluation Account". While this account will reflect the true worth of the investment, it must not be used for creating scrip shares. Also while the current dividend restraint continues all scrip issues made since 1st October 1976, shall not account, for the purpose of dividends.

(iii) Turn-over tax by building and construction industry: Most of the building and construction firms at present pay little or no tax at all, even though it is obvious they are enjoying a boom period. To correct this situation, Government has decided to apply the existing Turn-over Tax Decree of 1969 whereby all companies in the construction and building industry will pay either a turn-over tax of 2.5 percent (which will not be subject to deduction for capital allowance) or the normal Companies income tax, whichever is the higher.

(iv) Personal income tax: The following deicisions have been taken in respect of personal income tax:

(a) Personal allowance: In order to reduce the tax burden of those under the Pay-As-You-Earn system, a taxpayer is now entitled to either ₦ 600 or one-tenth of his annual earned income as allowance, whichever is higher.

(b) Dependent relatives allowance: Dependent relatives allowance is now to be granted to any person who has income in his or her own right.

(c) Children's allowance: A widow who remarries is now eligible to claim for the children of the deceased husband up to a maximum of four children.

(d) Rate of tax: The present rates of personal income tax after the first ₦ 10,000 of chargeable income have been revised as follows:
For every naira of the next ₦ 50,000 — 40k (40 percent)
For every naira of the next ₦ 5,000 — 45k (45 percent)
For every naira of the next ₦ 10,000 — 55k (55 percent)
For every naira over ₦ 30,000 — 70 k (70 percent)
Community tax rate has been increased from ₦ 4 to ₦ 5 to provide more funds for Local Government Authorities, Income rate has been abolished in respect of those who come under Pay-As-You-Earn system or Community tax.

> **TAXATION IN NIGERIA**
>
> Nigeria currently consists of nineteen states which to a certain extent have their own tax systems. However, most individuals and companies are subject to a uniform income tax. Customs duties are also uniform throughout the country.
>
> *Individual Income Tax:*
> rates range from 10-70 percent (on incomes over ₦ 30,000).
>
> *Company Tax:*
> 45 percent on all income exceeding ₦ 6,000.
>
> A summary description of the Nigerian tax system is to be found in *African Tax Systems*, a loose-leaf publication of the International Bureau of Fiscal Documentation.

(e) Taxation of fringe benefits:
(i) Rental expenses: Limits have been imposed on allowable rental expenses incurred on staff accommodation as follows:
(a) Lagos. A maximum of ₦ 14,000 per annum for a flat and a maximum of ₦ 28,000 per annum for a building.
(b) Other places. A maximum of ₦ 5,000 per annum for a flat and a maximum of ₦ 20,000 per annum for a building.
(ii) Car basic allowance: Legislation will be introduced in the year to make recipients of car basic allowance in excess of N 600 per annum liable to payment of tax on the allowance.

As well as these specific measures a general pledge was made in the Budget speech itself that

*"In view of the abundant evidence of widespread tax evasion among wealthy businessmen and women, and self-employed professionals, all the Governments of the Federation would institute stringent corrective and penal measures in the new year, to reduce the incidence of tax evasion".*

Among the exchange control policy measures announced the following should be noted:

"(i) Consultancy and technical fees: At present when foreign-owned companies undertake consultancy jobs in Nigeria, they are allowed to remit in foreign exchange up to a maximum of 60 percent of the contract fee. The rationale for such a high percentage is that most of the jobs would have to be performed outside the country since the facilities for carrying out such jobs are quite inadequate within Nigeria. Experience has, however, shown that the percentage could be lower. Accordingly it has been decided that the foreign exchange component will now be limited to a maximum of 50 percent but existing contracts will continue to be honoured.

(ii) Management fees: At present the foreign exchange regulation allows for a fixed fee in the first 5 years of the establishment of a Nigerian firm. Thereafter a maximum of 5 percent of gross profit might be allowed for deserving cases. It has now been decided that the maximum allowed by the foreign exchange regulation will be reduced to 3 percent of gross profit. As in the case of consultancy and management fees, existing contracts will continue to be honoured".

(iii) A task force will be set up to stop abuse of foreign exchange facilities. At present several black markets dealing in foreign exchange exist all over the country.

# CONFERENCE DIARY

## MARCH 1978

*British Branch of I.F.A.:* Tax workshop: Tax developments in the EEC, London (U.K.), March 16 (English).

*20th CIAT Technical Conference* (Inter-American Centre of Tax Administrators): Principal Problems in Tax Collection, Buenos Aires (Argentina), March 27 - April 1 (English, Spanish).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Copenhagen (Denmark), March 20-22 (English).

## APRIL 1978

*British Branch of I.F.A.:* The Meade Report, London (U.K.), April 5 (English).

*Financial Times Ltd.:* The Meade Report and Tax Reform, London (U.K.), April 6-7 (English).

*Business International Institute:* International Seminar (including International Taxation Theory, Transfer Pricing etc.). Port Chester, (N.Y., U.S.A.), April 17-28 (English).

*Management Centre Europe:* The growing pressure on international tax management, Zurich (Switzerland), April 19-21 (English, French and German).

*Management Centre Europe:* Tax management in a multinational environment (Seminar), Brussels (Belgium), April 4-5 (English).

*Seminar Services International:* The 8th "Multi-Choice" International Tax Planning Symposium. Part 1 (Introductory Course), April 12, 1978; Part 2 (Multi-Choice advanced seminars), April 13 and 14, 1978. Zurich (Switzerland) (English, French, German).

## MAY 1978

*British Branch of I.F.A.:* Anglo-U.S. Seminar, London (U.K.), May 4 and 5 (English).

*The International Tax Planning Association:* Annual Conference (subjects include: taxation in the Caribbean, offshore structures, trusts, change of residence, international transactions and measures taken by Governments to counter tax avoidance).

## JUNE 1978

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), June 19-21 (English).

## SEPTEMBER 1978

*32nd Annual Congress of I.F.A.:* I. The Taxation of Extractive Industries; II. The Differences in the Tax Treatment between Local and Foreign Investors and the Effects of International Treaties. Sydney (Australia) September 17-23 (English, French, German, Spanish).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (Seminar), Brussels (Belgium), November 7-8 (English).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

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FOR FURTHER INFORMATION PLEASE WRITE TO:

Australian Branch of I.F.A.: Bank of New Zealand House, 12th Fl. 333 George Street, Sydney 2000 (Australia).

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

Business International Institute: One Dag Hammarskjold Place, New York, N.Y. 10017 (U.S.A.).

Financial Times Ltd. Conference Organisation: Bracken House, 10 Cannon Street, London EC4P 4BY (U.K.).

Inter-American Centre of Tax Administrators: Apartado 215, Panamá 1 (Panama).

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

The International Tax Planning Association: c/o Investment and Property Studies Ltd., Norwich House, Norwich Street, london EC4A 1AB (U.K.).

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

Seminar Services International: 21-23 Chilworth Street, London W 2 3HW (United Kingdom); Passage Perdonnet 1, CH-1005 Lausanne (Switzerland).

# SRI LANKA:
# TAX PROPOSALS IN THE BUDGET FOR 1978

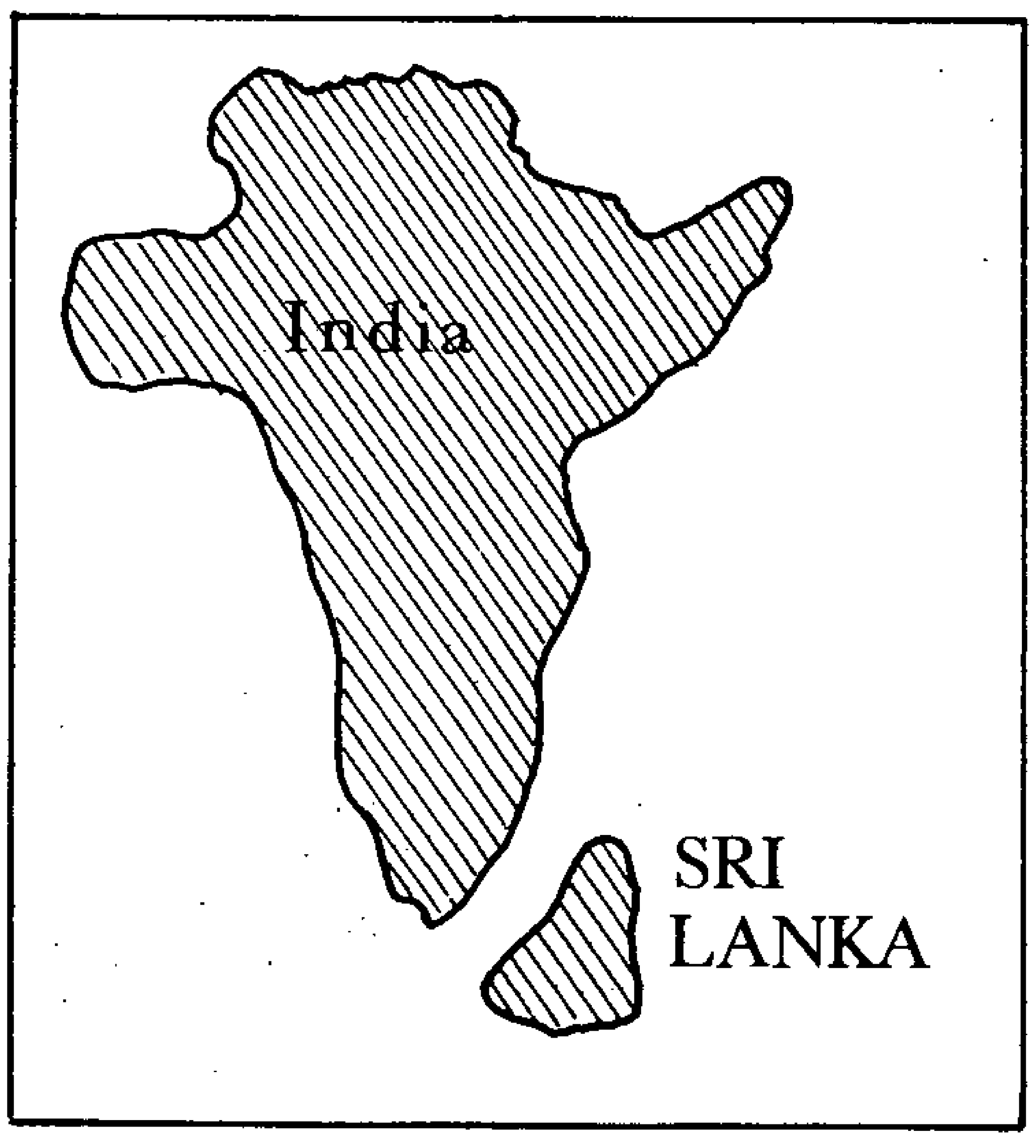
by M.P. Dominic

The Budget for 1978 was presented on November 15, 1977 by the Minister of Finance and Planning Mr. R.J.G. de Mel. The estimated additional revenue from the tax proposals contained in the Budget is Rs. 5,347 million. The tax proposals entail higher taxes on the affluent members of the society. However, the Minister has contended that the proposals are consistent with maintaining incentives for investment and development.

1. *Individual income tax:*
The marginal individual income tax rate will be increased from 50 to 70 percent.

2. *Abolition of expenditure tax:*
The expenditure tax which was introduced for the second time in 1976 is to be abolished. The tax is considered as unworkable and impractical in an economy like that of Sri Lanka. The revenue potential is small. The estimated revenue from such a tax is less than Rs. 2 million. Further, the Minister has stated that since the marginal individual income tax rate has been raied to 70 percent, there is no rationale for the tax to continue.

3. *Depreciation allowance and development rebate:*
A 100 percent lump sum decpreciation allowance will be granted in the first year of use with respect to plant, machinery and fixtures used in a business. The lump sum depreciation allowance in respect of agricultural and industrial buildings is limited to 50 percent of the cost of construction. However, a 100 percent lump sum depreciation allowance will be permitted in respect of houses built by an employer for the use of his employees other than the executive staff. At present, a lump sum depreciaton ranging from 33 1/3 to 50 percent is granted. In addition, a development rebate of 20 percent or 40 percent is allowed. The development rebate will be discontinued.




4. *Income tax incentives:*
(a) A five-year tax holiday will be given for companies formed to undertake food production, horticulture and animal husbandry.
(b) A five-year tax holiday will be allowed for new small and medium scale industrial undertakings if they are located outside Colombo.
(c) A five-year tax holiday will be granted for new companies formed for the purposes of carrying on offshore and deep-sea fishing. In addition, all subsidies granted by the Ministry of Fisheries to any undertaking or individual in respect of fishing vessels, fishing gear and equipment for offshore and deep-sea fishing will be exempt from income tax.
(d) House builders approved by the Commissioner for National Housing will be fully exempt from tax on income arising on the sale of any house, the construction of which was commenced and completed after July 22, 1977, if the floor area of the house does not exceed 500 square feet. The exemption will be limited to 50 percent of the profits if the floor area of the house exceeds 500 square feet and does not exceed 2,000 square feet.
(e) The tax rebates introduced in 1976 in respect of investments in accordance with approved investment plans, investment in housing and land development projects, increase of employment, increase of production export and for obtaining foreign exchange will be abolished. They have had "no impact whatsoever on development. These provisions have only had the effect of further complicating the tax statute". [1]

5. *Capital gains on gifts and death:*
The tax on notional capital gains levied on gifts and on death will be abolished. Only the realised capital gains will be subject to tax.

6. *Wealth tax:*
The aggregate wealth tax and income tax liability may not exceed 80 percent of a taxpayer's income from all sources including exempt income.

7. *Estate duty and gift tax:*
A single rate schedule for both estate duty and gift tax will be introduced. Tax will be payable on the aggregate of the gifts made. Credit will be given for the tax due on the previous gifts. The estate will be treated as the last gifts. It is argued that the application of a simple rate schedule for gift tax and estate duty will favour distribution of property during the lifetime of a person.

8. *Estimated assessment by the Assessor:*
The Assessor will be required when he rejects the returns made by the taxpayer, to conduct an inquiry and issue an order giving the reasons for the rejection of the returns and for estimating the taxpayer's income. This will apply also for purposes of business turnover tax.

9. *Time limit for making assessments:*
Additional assessments on a taxpayer may not be made after the expiry of three years from the end of the relevant year of assessment. At present, the time limit is six years. The time ban will not be applicable in the case of fraud or wilful evasion.

10. *Establishment of free trade zone:*
A free trade zone consisting of 200 square miles will be established.

11. *Double taxation relief agreements:*
Special importance will be given to the negotiation of double taxation relief agreements so that tax concessions which will be granted in connection with the establishment of a free trade zone will benefit the investors concerned.

12. *Tax commission:*
A tax commission composed of persons from abroad and Sri Lanka will be appointed to make full review of all tax laws and tariffs.

13. *Business turnover tax:*
For purposes of reducing prices, the previous 10 rate bands ranging from 1 to 35 percent will be reduced to 3 rate bands of 1 percent, 5 percent and 10 percent. However, special rate bands apply to tobacco, liquor and the assembly of motor vehicles. In addition, the exemption limit is increased from Rs. 75,000 to Rs. 100,000.

14. *Import duties:*
As a consequence of import liberalization, the protection granted to local industries through import restriction will be given through import tariffs. "The tariffs would afford the necessary degree of protection which, while ensuring the continued existence of efficient local industries, also ensures that inefficient, poor quality, and unreasonably high priced local production resulting in the exploitation of the consumer does not take place." [2] There are six bands — duty free, 5 percent, 12.5 percent, 50 percent and 100 percent. The Government expects to collect Rs. 1,150 million by way of import duties.

1. The National State Assembly Debates, Official Report, Vol. 24, No. 1, p. 363.
2. Ibid, p. 371.

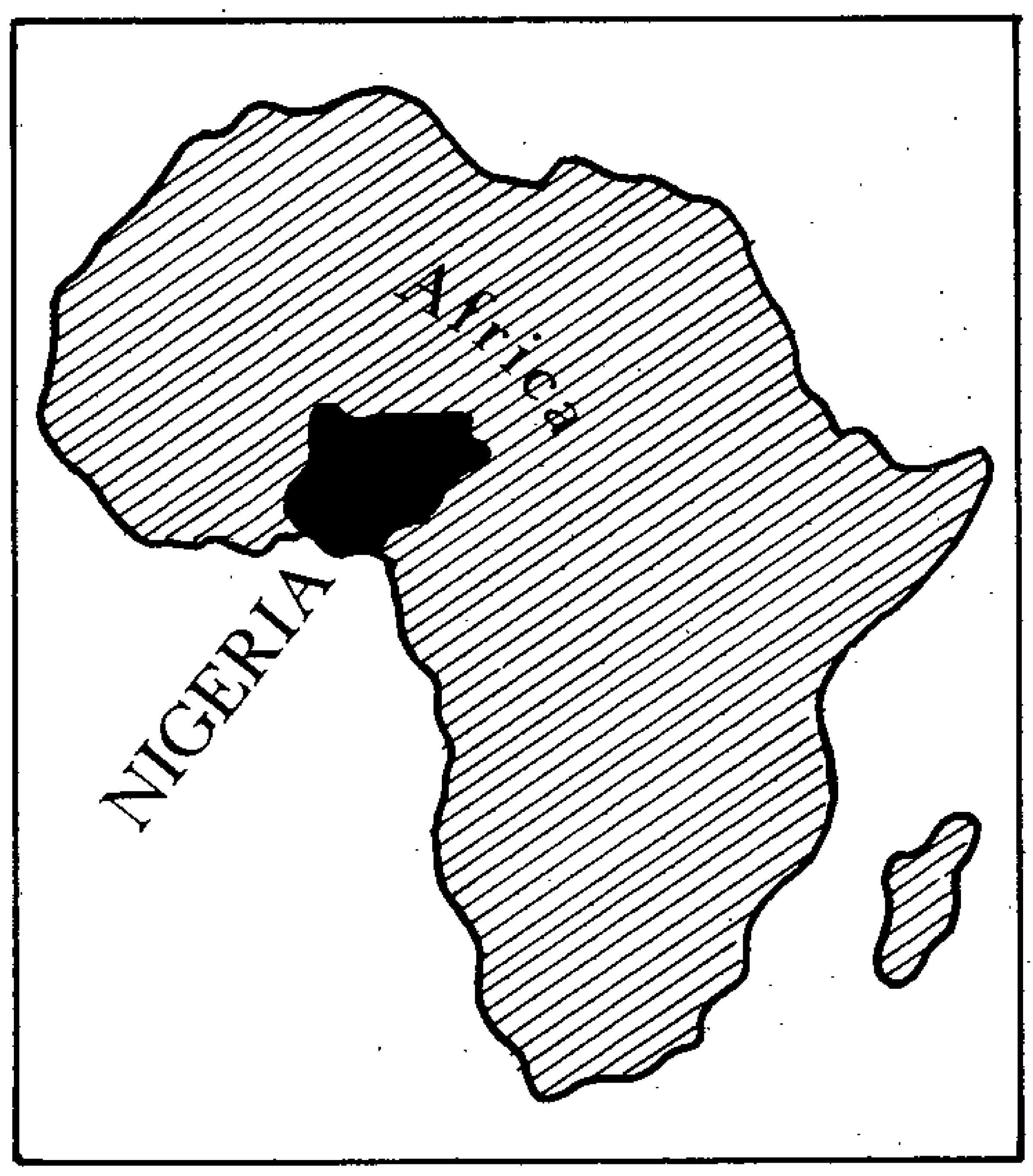
*15. Permanent tariff commission:*
A permanent tariff commission will be set up and it will be entrusted with the task of harmonizing, reviewing and revising the various fiscal levies with special emphasis on import tariff rates.

*16. The export duties:*
The export duty will be increased to Rs. 15/50 per kilo for packetted teas and bags. A new sliding scale of duties is applicable to rubber exports. The export duty on desiccated coconut is 60 percent of the f.o.b. value.

*17. Abolition of the transfer tax on motor cars:*
At present, a tax of 80 percent of the difference between the landed cost and appraised value is being charged on the transfer of a car by an importer within seven days of such importation. In its place, a transfer fee of Rs. 5,000 on motor cars 17 cwts and below in weight and Rs. 10,000 on cars above 17 cwts in weight will be levied on the first transfer after importation.

*18. Abolition of FEECs — (Foreign Exchange Entitlement Certificate Scheme)*
A unified exchange rate is introduced and it will be permitted to float in response to basic exchange rate developments and the country's balance of payments objectives. As a consequence of this exchange reform, the FEEC Scheme was abolished. Under the FEEC Scheme, for every Rs. 100 worth of foreign exchange remitted out, Rs. 65 must be paid to the Central Bank, and, for every Rs. 100 worth of foreign exchange remitted into Sri Lanka, Rs. 65 was paid to the person remitting it. As a consequence of the abolition of the FEEC Scheme, the Government is expected to lose Rs. 1,300 million.

# NIGERIAN BUDGET 1977~78




The Budget proposals for 1977-78 were outlined in a radio broadcast on March 31, 1977 by His Excellency Lieutenant-General Olusegun Obasanjo, Head of the Federal Military Government and Commander-in-Chief of the Armed Forces of the Federal Republic of Nigeria.

Details of the general proposals outlined in the Budget speech were later given in a press statement by the Federal Commissioner for Finance and the main points from this statement are reproduced below: The Commissioner introduced his statement as follows:

*"In his analysis of the economic background to the Budget, the Head of State emphasized that although the underlying tone of the economy is sound and great progress was made in such areas as stimulating sustainable economic growth and moderating the rate of inflation, the achievement of other major goals of our economic policy, such as the balancing of our internal and external accounts has so far remained illusive. Even in the area of price development where the rate of inflation has decelerated, the current double-digit growth rate of 22 percent is still too high for Government to relax its efforts in the fight against inflation. In other words, the present state of our economy does not permit of a full scale relaxation of the restrictive and corrective measures introduced in the 1976-77 Budget. Therefore, the 1977-78 Budget has attempted to broaden the scope of some of those measures and introduce new ones where necessary".*

**BUDGETARY PROCEDURE**

The normal budgetary procedure in Nigeria is that proposals are first discussed in the highest policy making body, i.e. the Supreme Military Council. After approval by this body they are announced over the radio and television by the Head of State. Subsequently the Commissioner for Finance gives a greater detail and a further breakdown of the announced measures, usually at a press conference. So far as the measures of the 1977-78 Budget are concerned they became effective on April 1, 1977. The Budget measures are usually later formally enacted in an Appropriation Decree.

The main fiscal measures relating to the customs and excise tariff and import prohibition had, the Commisioner said,

*"been formulated to achieve the following objectives:*
*(i) industrial peace and stability;*
*(ii) economic growth especially in the productive sector; and*
*(iii) to bring further down the rate of inflation.*

and with this in mind were as follows:

1. *Agriculture*

Not only self-sufficiency but also export surpluses should be the aim here. Large scale commercial agriculture must be encouraged as well as the modernising of the traditional agricultural sector. New measures proposed to assist agriculture and agro-allied industries, therefore, included the following:
(i) tax relief by means of the Pioneer Certificate for at least five years for any agricultural or agro-allied project using locally produced raw materials;
(ii) exemption from import duty for all raw materials used in the manufacture of livestock feed.
(iii) exemption from import duty of machinery used in food and agricultural processing.

2. *Manufacturing industry*

The 1976/77 Budget reduced import duties payable on imported raw materials and the current budget proposed additional protection and incentives for local industry as follows:

Rates of duty on certain imported goods which compete with locally-produced goods have been increased; these include men's and ladies outer garments, shoes, textile fabrics and tyres. Reductions in duty are provided on the other hand, for many types of raw materials including sunthetic rubber latex and carbon black for the tyre industry, parts for the manufacture of primary batteries and electric filament lamps, and barley and hops for the brewing industry.

It is too early to forecast developments in the Caribbean where land taxes were only recently installed. It is worth noting, however, that Trinidad and Tobago's land value tax is modified to cover improvements in excess of a specified value. Also, the original proposal for Jamaica called for a supplemental low rate on improvements that would operate as a charge for municipal services. The analogy with the system in most Australian states can be explained by the nationality of the expert advisor. This view is also reflected in Papua New Guinea's ordinance which provides for a tax on improvements that has not been implemented.

## IV. CONCLUDING OBSERVATIONS

This brief survey of developing countries' experience with land value taxes suggests that they have fallen far short of earlier expectations. Not more than a dozen or so countries that are now in the development stage have adopted this type of property tax, in pure or mixed form; two of these — Tanzania and Zambia — are in the process of phasing them out, and four — Barbados, Jamaica, Papua New Guinea, and Trinidad and Tobago — have only recently enacted site value taxes. Other countries have either supplemented site value taxes with taxes on improvements or are giving serious consideration to this step.

It should not be thought that site value taxes are administered with less success in developing countries than property taxes based on capital value or annual value. Their administration is beset by even greater problems than site value taxes and their record is not an encouraging one. But while site value taxes appear to have certain advantages, they also have institutional and administrative limitations that restrict their use.

In many developing countries, especially in tropical Africa, the basic system of land tenure and registry is not sufficiently established to permit a viable system of land taxation. Even when a system of land titles or leaseholds exists boundaries are ill defined, claims to land are unsettled, and the market for real estate is not well enough developed to establish realistic values. (Nationalization of land and restrictions on its transfer have accounted for the demise of land value taxes in Tanzania and Zambia.) In the urban areas of many other countries housing tenancy predominates and provides a more convenient basis for assessing property taxes on annual value rather than capital value.[38]

Where conditions of land tenure permit, the preparation of a site value cadaster is a major project that few developing countries are equiped to undertake. Most countries would be unwilling to reform an existing property tax system along this line unless there were compelling reasons to do so on grounds of equity, economic development, administrative convenience, or revenue. Yet several developing countries have surmounted these problems since the end of World War II, the most notable examples being Barbados, The Republic of China, Jamaica, Papua New Guinea, and Trinidad and Tobago.

Problems of delineating property boundaries and resolving conflicting claims inevitably exist, although these are more serious in rural than urban areas. Large scale maps that are necessary to identify and to reference ownership are frequently unavailable. While it may be expedient under these circumstances to employ a fiscal cadaster resting partly on occupancy, this may be a source of difficulty in enforcing the tax. Aerial mapping has proved to be a useful, if costly, instrument for supplying this need.

Perhaps the most serious problem is in organizing a valuation department and staffing it with technicians qualified to undertake the mapping referencing, and valuation of property. The lack of trained valuers makes it necessary to mount a major training program that results in delays and inefficiency. Even so, the staffing requirements for a land value tax are considerably less than those for either a capital value tax (including improvements) or an annual value tax. Land valuation techniques have been perfected that can be computerized, whereas the determination of the capital value of buildings calls for periodic inspection of each building by technicians trained in engineering and related skills. The experience in the Caribbean nevertheless shows that many years are required to install a new land value cadaster, even for a small country such as Barbados. But having established a trained organization, this work can be expedited as it was in Kingston, Jamaica.

Once a land value cadaster is put in place it is important to maintain it by recording changes in land boundaries, changes in ownership, and changes in value. Neglect of any of these requirements leads to a deterioration of the system, inequities among landowners, and loss of revenue. A land registration system for recording changes in ownership and recording prices is indispensable.

If a land value tax is to fulfill its functions of recapturing increases in land value by the government, arresting land speculation, promoting urban development, and providing revenue, it is important to maintain land values at current market prices. Legislation typically provides for revaluation every five years but in a period of rapidly rising land values this is not frequent enough. Revaluations are often postponed long beyond the legal cycle, with the result that the cadaster becomes even more distorted because of the uneven changes in land values in different districts. Such neglect may sometimes be attributable to political factors and failure to provide the necessary funds. It may also be explained by a scarcity of trained valuers in developing countries, which appears to be universal. Unless rates are adjusted to compensate for the lag in cadastral values, site value taxes have negligible effects on land use decisions and they fall far short of realizing their principal objectives. In the Republic of China, for example, it is estimated that rates in 1975 averaged no more than 0.5 percent of market values as against about 1.7 percent of assessed values. Rather than accept the full effects of the revaluation of 1974 the Government announced a 40 percent reduction in rates for 1976.

38. This is said to be the case for India, Pakistan, Singapore, and Sri Lanka, among other countries. See Lent, "The Urban Property Tax in Developing Countries", pp. 54-55.

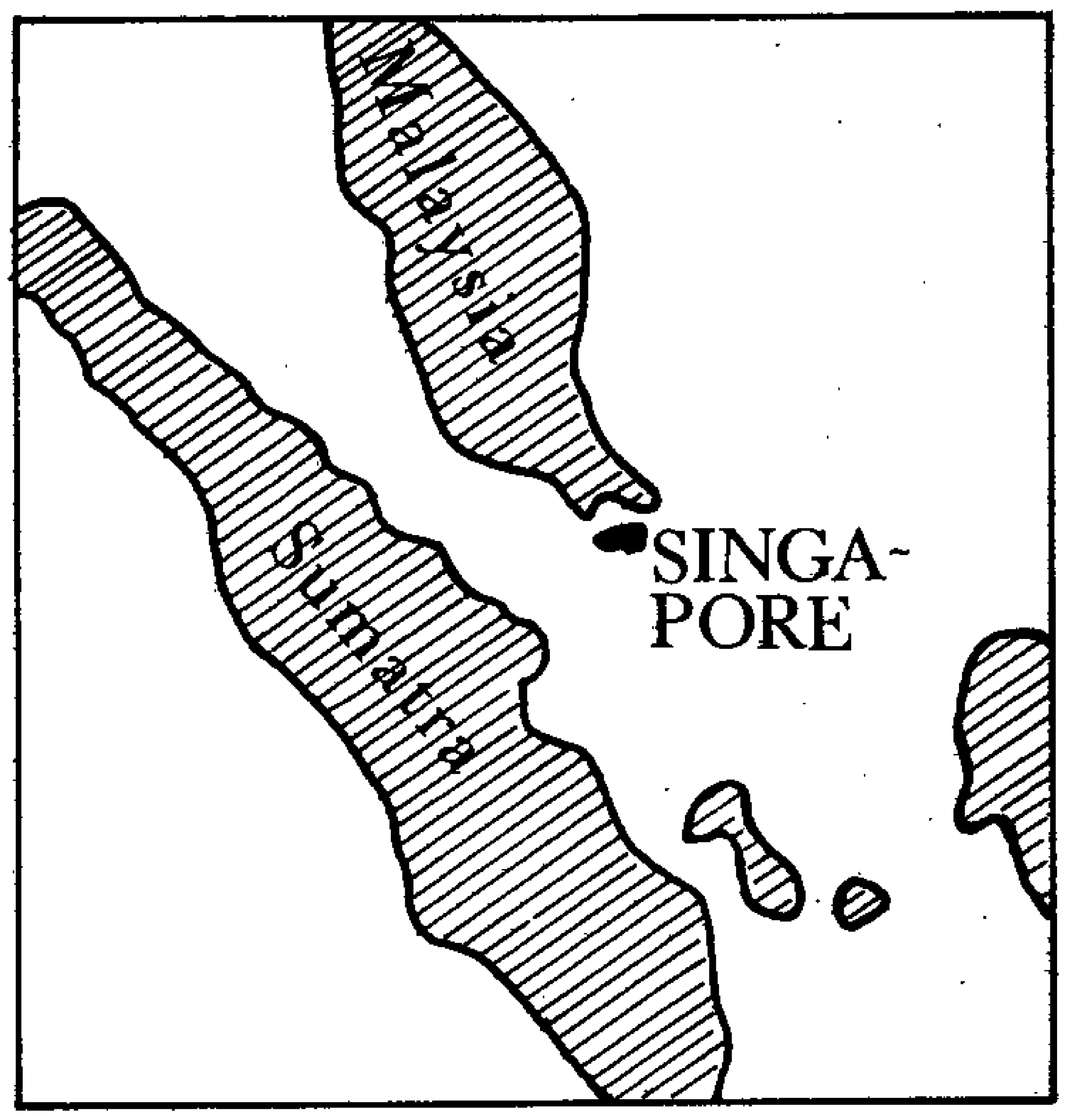
The failure to maintain cadastral values in developing countries partly explains increasing disenchantment with land value taxes and steps for reform. Unless land values are kept current, land tax revenues fail to respond to the growing financial requirements of the cities or other levels of government. As a result, tax rates are increased or steps are taken to supplement the tax base by the inclusion of improvements or the enactment of other tax measures. The broadening of the property tax base may be justified by the belief that land tax rates have reached tolerable limits, or the belief that the value of improvements is not contributing adequately to the provision of government services. This has been the history of land taxes in more developed countries of the world, such as Australia, Canada, New Zealand, and South Africa. And this might set the pattern for the future development of land taxes in the developing world.

# SINGAPORE:

## MINISTRY CLEARS THE AIR ON TAX CHANGES

**(Interpretation of Section 12(6)(a), Section 12(7)(b) and Section 12(7)(c) of the Income Tax (Amendment) Act, 1977)**

by Lee Fook Hong, FCIS, FAIA




The Income Tax (Amendment) Act, 1977 came into effect on July 7, 1977. A summary of the tax changes introduced by this Amendment Act was discussed in the August/September 1977 Issue of the Bulletin. Some of the provisions in the Income Tax (Amendment) Act, 1977 are ambiguous and the misinterpretation has caused some confusion.

In view of the confusion and in order to clear the air on tax changes, the Ministry of Finance of the Republic of Singapore issued a press statement setting out the ruling on Section 12(6)(a), Section 12(7)(b) and Section 12(7)(c) of the Income Tax (Amendment) Act, 1977. The Ministry statement is reproduced below: —

"The Income Tax (Amendment) Act, 1977 which came into effect on July 7, 1977 introduced certain provisions which have the effect of frustrating tax avoidance schemes in siphoning off Singapore profits, particularly between associated companies in Singapore and outside Singapore. However, some of these provisions have been given more than one possible interpretation, thus giving rise to doubt on the scope and amount of payments to non-residents subject to tax. For the purposes of clarification and case of administration, where the following services are performed outside Singapore by persons outside Singapore for or on behalf of residents or permanent establishments in Singapore, or even between associated companies, and such transactions are at arm's length and not with intent of siphoning off Singapore income, the Commissioner of Inland Revenue has given the following rulings: —

(a) *Commission, fees of any other payments in connection with any arrangement, guarantee, management or service relating to any loan or indebtedness — Section 12(6)(a) of the Income Tax Act*

Where the arrangement, management, guarantee or service is performed outside Singapore, the payments for such arrangement, guarantee, management or service are hereby treated as not covered by the provisions of Section 12(6)(a).

(b) *Any payment for rendering of assistance or service in connection with the application or use of scientific, technical, industrial or commercial knowledge or information — Section 12(7)(b) of the Income Tax Act*

Where the assistance or service is performed outside Singapore, the payment for such assistance or service is hereby treated as not covered by the provisions of Section 12(7)(b). This does not refer to royalty which has always been subject to tax even before the 1977 Income Tax Amendment.

(c) *Any payment for the management or assistance in the management of any trade, business of profession — Section 12(7)(c) of the Income Tax Act*

Reimbursement or allocation of administrative expenses incurred by head office outside Singapore and claimed by a branch in Singapore is governed by the provisions of Section 14 as before. This also applies to reimbursement or allocation of expenses between associated companies. Both are not affected by the provisions of Section 12(7)(c). Payment to persons outside Singapore not associated to the payers in Singapore are hereby treated as not covered by the provisions of Section 12(7)(c)."

With the above rulings, the practice of treating these payments vis-a-vis the recipients outside Singapore remains the same as before the 1977 Amendments.

The necessity of having the definition of "permanent establishment" has been well understood by the professional bodies. However, there has been some doubt whether more storage of goods in warehouse would give rise to tax liability as the word "warehouse" is included in the definition. It is reiterated that the mere storage of goods in warehouse without carrying on business in Singapore will not give rise to any tax liability.

# TAX GLOSSARY

*by H.W.T. PEPPER **

**EARMARKING OF REVENUE** — Earmarking or hypothecation of revenue is the term applied to the levying of a specific tax to meet a specific government expenditure. A historical example in Britain was the allocation of vehicle taxation to a "Road Fund" to meet the cost of improvements and maintenance of roads, and a modern example is the payroll tax in Australia which is used to provide family allowances. In general, earmarking is not regarded as desirable because the flow of revenue is unlikely to follow precisely the same fluctuations as that of the expenditure it is intended to cover. The yield of revenue varies with taxable capacity which, in turn, depends on the economic growth of a country while expenditure under a particular heading will vary according to the number of projects undertaken in a particular year, and other factors which do not necessarily have direct connection with economic growth. It is in any event desirable that public expenditure should be specifically controlled on an allocation of resources basis.

**EARNED INCOME** — Income derived from personal exertion in an employment, trade, business, profession, or vocation is known as "earned income". The income of a sleeping partner in a business partnership is not regarded as earned income, but the pension of a retired employee representing, in effect, "deferred remuneration" of his employment is regarded as earned income.

**EARNED INCOME, RELIEF FOR** — A special deduction, normally a fraction or percentage of earned income up to a certain ceiling, was introduced in Britain in 1907 (initially by charging earned income at a lower tax rate than investment income) and has been adopted also in the income tax laws of a number of Commonwealth countries, but is not usually encountered outside the Commonwealth (see, however, EMPLOYMENT INCOME DEDUCTION). The justification for a special kind of relief is that earned income is ephemeral in that it ceases when the earner dies or becomes disabled, whereas investments will continue to produce income without exertion by the investor. Alternative methods of differentiating between earned and investment income include the levying of additional income tax on investment income (a method proposed for introduction in Britain from 1973/74) or the levying of wealth tax on the capital which produces investment income. The U.S.A., for example, now has a top income tax personal rate of 50 percent on earned income and 70 percent on investment income, and Sri Lanka, India, and Pakistan, among others, have wealth taxes. A number of countries levy annual wealth taxes and a much larger number impose capital levies in the form of DEATH DUTIES (q.v.) on the capital transmitted by a deceased person to his heirs.

**EARNINGS BASIS** — When profits are computed for income tax purposes on the basis of the amount earned in the tax year, i.e., on the basis of goods sold and services rendered (whether paid for or not in the tax period) with deductions for purchases made and expenditure incurred (whether paid for or not), the profits are said to have been computed on the "earnings basis". The earnings basis is also, in effect, used as the basis for levying sales tax when the trader is charged in respect of goods delivered or sold and/or services rendered, regardless of whether the goods or services were paid for during the tax period. Where the earnings basis applies, an allowance for BAD DEBTS (q.v.) may be made where the goods sold or services rendered are not ultimately fully paid for.

**ECONOMIC DOUBLE TAXATION** — There is said to be economic double taxation where corporate income is taxed as such and then taxed again when received as dividends by the shareholders who collectively own the company which has made the profits. The point is taken that the distribution of corporate income does not in substance create a new body of income (although this is the legal position) and that to tax both items is to load the tax system unduly heavily against income earned by companies and corporations compared with the position, say, of partners in a parnership. It is *not* the usual practice to tax partnership income separately from the partners and then tax the partners when they draw their shares of income for personal use. Economic double taxation may be avoided or abated either by giving relief to the company when it distributes taxed income (which will then be assessed upon the shareholders) or by giving relief to the shareholders in respect of the IMPUTED or UNDERLYING TAX (q.v.) already paid by the company. Some tax systems allow private or "close" companies to opt for partnership treatment to avoid economic double taxation (see, e.g., Section 1371 of the U.S. Internal Revenue Code).

**ECONOMIC STABILISATION TAX** — A tax introduced in Zaïre in February 1972 in the form of a 5 percent additional levy on "non-essential" imports.

**"ECONOMY"** — One of the "CANONS OF TAXATION" (q.v.) which postulate, inter alia, that taxes should be administered with due economy since if too much of the tax yield is absorbed in the cost of collecting it, it would generally be preferable to switch to some other form of taxation where the burden upon the taxpayer coincides more nearly with the yield to the government. Neglect of this principle, e.g., by TAX "FARMING" (q.v.) or other inefficient ways of collecting taxes, has been a contributory factor in the decline of some of the civilisations of antiquity.

**E.E.C. DIRECTIVES ON HARMONISATION** — The 9 member countries of the E.E.C. (see EUROPEAN ECONOMIC COMMUNITY) have agreed to harmonise their tax legislation and in order to achieve harmonisation in practice the Commission of the E.E.C. Council has issued various Directives or Proposed Directives (to give opportunity for further comment) in respect, for example, of V.A.T. and corporation tax.

**EFFECTIVELY CONNECTED INCOME** — Non-resident alien individuals and foreign corporations engaged in trade or business within the U.S. are subject to U.S. income tax on income, from sources both within and outside the U.S., which is "effectively connected"

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

with the conduct of the trade or business within the U.S.

**EINKOMMEN** — (German) Total income, i.e., the aggregate of the EINKÜNFTE after deduction of the special expenses.

**EINKOMMENSTEUER** — (German) Income tax.

**EINKÜNFTE** — (German) Items regarded as income for W. German tax purposes.

**EISERNER BESTAND** — (German) BASE STOCK (q.v.) method of valuation.

**EJENDOMSKAT** — (Danish) Property Tax.

**ELECTION** — (U.K.) Where some option is open to a taxpayer to choose if it benefits him to do so, the procedure is sometimes called making an election for, or opting for, the more beneficial course.

**ELEMENTS IN VALUATION** — The valuation commonly adopted for goods under customs duty enactments (e.g., where the Brussels definition of value is adopted) includes the following elements:

(a) the open market price of the goods, the exporter and importer being independent of each other;
(b) the freight and insurance costs of bringing the goods to the importing country; and
(c) the unloading and delivery costs of bringing the goods to the import point in the importing country (e.g., the warehouse where the importer will take delivery).

**EMIGRATION TAX** — See ACADAMIC TAX.

**EMPLOYMENT INCOME DEDUCTION** — (Japan) A variable deduction from employment or pension income, commencing at 40 percent + a fixed sum for the lowest incomes and increasing to 10 percent + a larger fixed sum subject to a maximum fixed sum over a certain income ceiling. See also EARNED INCOME RELIEF.

**END PRODUCT TAX** — Certain products have traditionally been taxed on their constituents, i.e., at an early stage in manufacture and distribution, so as to minimise the scope for evasion of duty or tax. For example, tobacco leaf was usually taxed heavily on import, instead of waiting to tax the finished products, cigars, cigarettes, and shredded tobacco for pipe-smoking. Similarly, alcohol was usually taxed by reference to the raw spirit distilled, or to the quantity of fermentative materials employed in a brewing or distilling process to produce alcoholic beverages. The present tendency, however, is to tax mainly the end product, e.g., bottled beer, whisky, brandy, gin, etc. by sales or excise taxes. In the case of tobacco, the end product tax will be levied on the actual number of cigarettes produced. The trend reflects the greater tax security possible in checking taxable outputs as machinery becomes complex and book-keeping methods more efficient.

**END USE** — (Canada, etc.) The end use of a product may be its actual consumption, or its use as capital equipment, as distinct from its use at an earlier stage of production as raw material, fuel, or as a constituent, component, or catalyst. Double taxation, i.e., of an end product and its constituents may be avoided by an offsetting arrangement, or "automatically" under a V.A.T. regime.

**ENERGY TAX** — The theoretical concept that, broadly speaking, the more affluent a person is, the more energy, in the shape of gas, coal, motor spirit, electricity, he will use, led to a French proposal that sources of energy in general should be taxed progressively according to usage by the customer. In practice, hydrocarbon oils are commonly taxed heavily (at a flat rate) and occasionally a modest sales or excise tax is placed on electricity or gas. In general, however, fuels used domestically by personal consumers, and by industrialists, are not taxed, or are taxed lightly: the levying of heavier taxation as a kind of tax on affluence would involve serious anomalies.

**ENFORCEMENT** — Enforcement of a tax means ensuring that it is duly paid by the taxpayer, involving legal action, etc., where necessary to enforce payment, and also the process of ensuring that the tax paid is the amount correctly due from the taxpayer, which involves checking of audit processes to confirm that his declaration of income, sales, etc., is an accurate one.

**ENREGISTREMENT, DROITS D,** — (France, Belgium) Registration taxes comprising, inter alia, DROIT D'APPORT, DROIT DE DONATION, and DROIT DE SUCCESSION (q.v.).

**ENTERTAINMENT EXPENSES** — Expenditure incurred on the entertainment of customers by a salesman, representative or advertising or publicity man in the attempt to sell goods and services is sometimes regarded both as something which can be reasonably deducted in arriving at profits, but which at the same time is highly susceptible of abuse by the claimant. Accordingly, various attempts have been made to ban or restrict the allowance of this kind of expenditure in computing taxable income. For example, there was a complete ban of such deductions in Sri Lanka following an advisory visit by Dr. Kaldor, and in Britain deductions may now only be claimed where such expenditure is incurred in connection with foreign buyers in an attempt to generate export trade.

**ENTERTAINMENT TAXATION** — Entertainment duties and taxes are those levied upon various forms of entertainment, such as may be provided by theatres, cinemas, cabarets, nightclubs, casinos and sporting events, usually by way of a tax on charges for admission, table or cover charges, or the "house percentage" in the case of gambling. (See also ADMISSION TAXES.) At various stages in economic history, tax legislators have distinguished between "live" and "canned" entertainment in favour of the former, in favour of moving picture theatres compared with television and in favour of "participation" sports, such as football and cricket as compared with horse and dog racing. Such distinctions have been made on various grounds, such as a desire to favour creative, artistic, or healthful activities, and those less economically viable, compared with those regarded, at the time the distinction was drawn, as less worthy of favour. Under a V.A.T. system, a flat rate tax may apply to all forms of entertainment or the tax rate may be modified by exemptions or supplementary taxes.

**ENTNAHMEN** — (German) Non-deductible business expenses.

**ENVIRONMENTAL TAX** — This term was applied to a proposed tax by New York City which would have applied to most plastic containers which the Citu contended presented special disposal problems in incinerators and when used as land filling material, The tax was contested by the plastics industry (see also ANTI-POLLUTION TAX).

**EQUALISATION OF BURDENS TAX** — A tax (AUSGLEICHSTEUER) imposed in Federal Germany after World War II as a CAPITAL LEVY (q.v.) on a taxpayer's total property owned on 21 June 1948. The tax was charged at 50 percent but payment could be spread over 30 years, with suitable additions for interest on the unpaid balance.

**EQUITY** — Equity is another of the CANONS OF TAXATION (q.v.). The principle is that taxes should be equitable in their incidence on different sections of the tax-paying community, e.g., proportionate to their respective taxable capacities. (See also DOMESTIC TAX EQUALITY and GRADUATION.)

[ to be continued ]

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# Contents

of the March 1978 issue



**In next issues:**

Japan: The Tax Committee recommends a large scale tax increase
— by *Makoto Miura*

Fiscal Incentives for Japan's Exports and Direct Foreign Investment
— by *Tomotaka Ishimine*

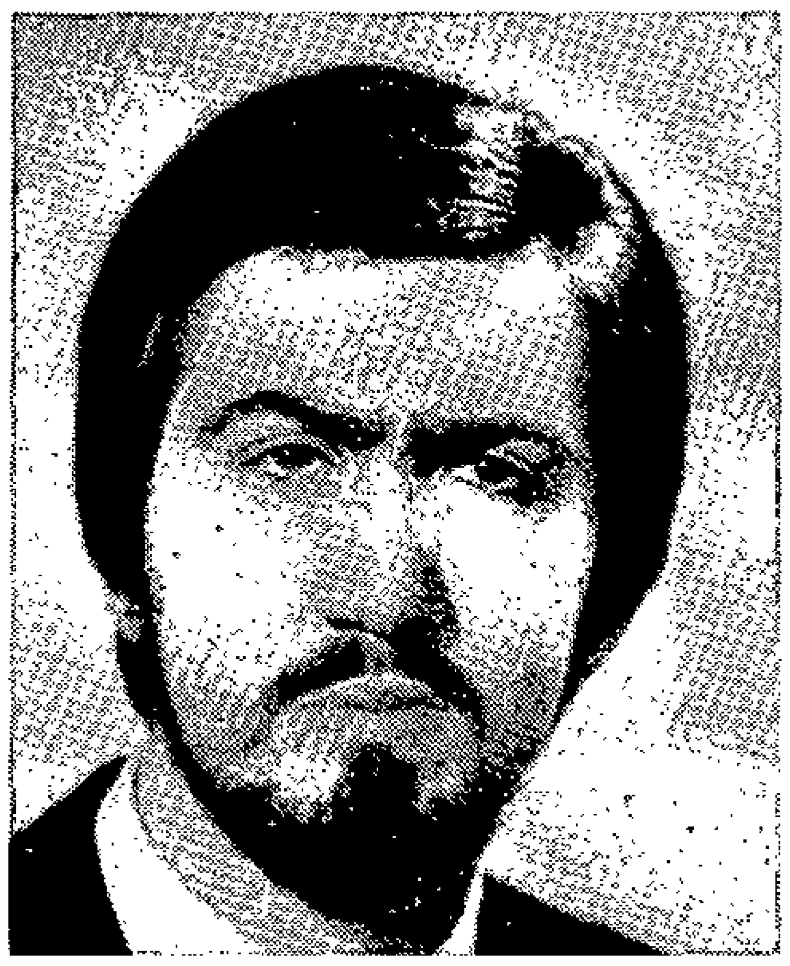
ASEAN: Recent Development in Trade Preferences and Comprehensive Double Taxation Agreements
— by *Jap Kim Siong*

Legal Regulation of Taxes, Levies and Fees in the Czechoslovak Socialist Republic
— by *Dr. Milan Bakes*

The German Corporation Tax Reform and the Revision of Double Tax Treaties
— by *Dr. Theodor Faist*

The 1978 Income Tax Changes in the Republic South Africa
— by *Dr. Erwin Spiro*

The Future of Personal Income Taxation
— by *Dr. Barry Bracewell-Milnes*



# MONACO ~ FRANCE

## united and separated

## by their law and tax systems

CHRISTIAN LAROCHE

ALEXANDRE KURGANSKY

## I. INTRODUCTION

Table of contents



1 — Recalling momentous events in world politics in the years 1962-1963, it will occur to no one to mention the conflict between France and Monaco. It is from the extreme rarity of this kind of inter-state conflict that its interest arises in so far as tracing its origins is concerned as well as assessing its significance in the special relations between the two neighbour states, in the present and in the future.

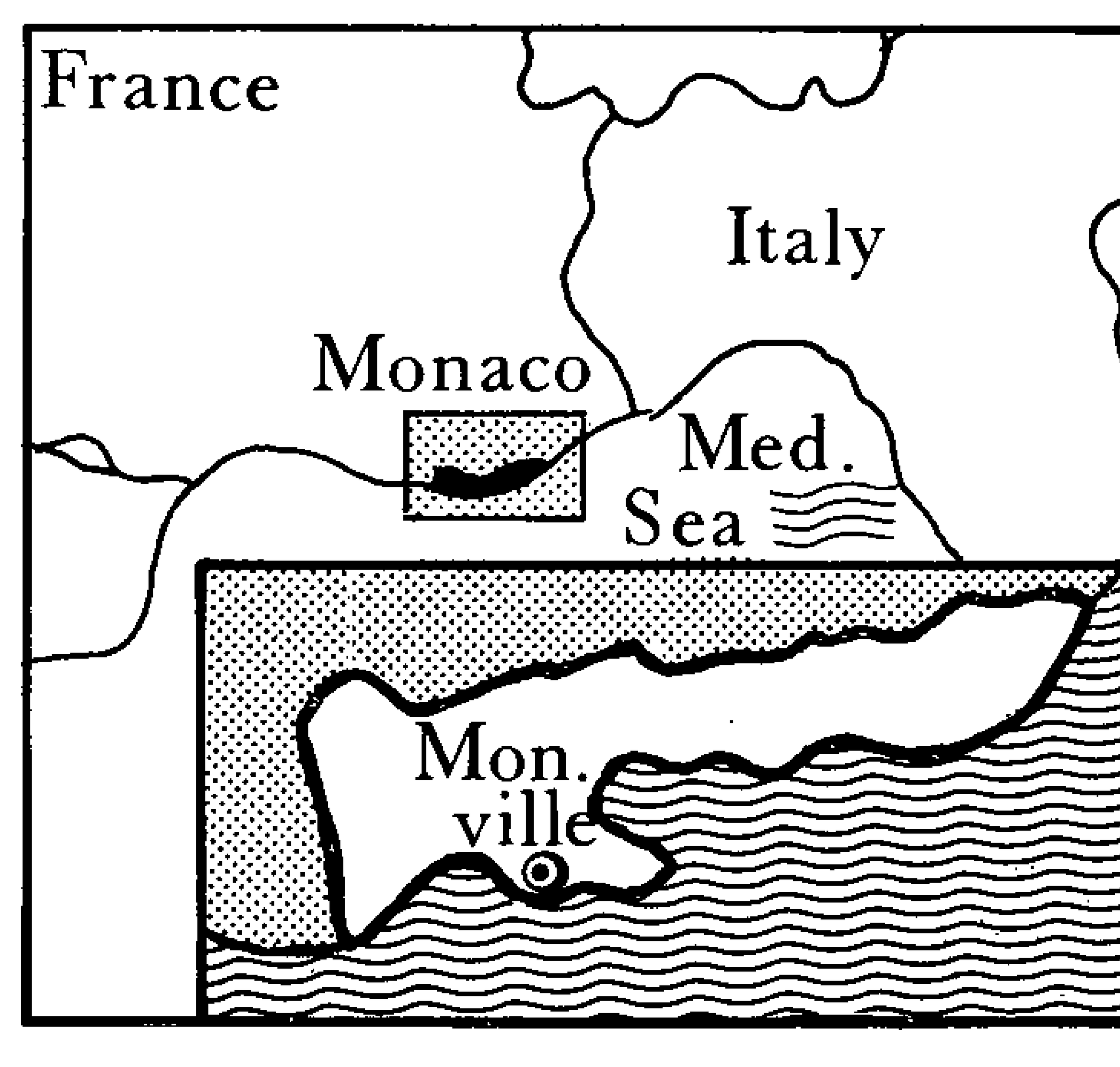
### Monaco a quasi tax haven

2 — One often wonders whether the phrase "tax haven", applies to microstates; although certain authorities put the Principality among those, we prefer to use the term "quasi tax haven", which seems to be the most adequate to describe a state where the burden of taxation may vary along a zero to a hundred scale.
Although the French Government never intended to question the *de jure* independence of the Principality, an independence which France has bound itself to protect in an international treaty, [1] its action in 1962 falls within the frame of the struggle initiated by industrialized countries to curb international tax evasion and avoidance.

3 — Whereas the Principality's fiscal privileges have been confirmed since the fourteenth century, the special situation of the tiny State has existed only since the end of the last century — the abolition of assessed taxes on Monegasque territory was one of the consequences of the surrender to France in 1861 of four-fifths of the territory of Monaco. In exchange, France formally recognised the independence of the Principality. It was paradoxically within the frame of a customs agreement and "convention de bon voisinage" signed in 1865 between the Principality and its powerful neighbour that Monaco was to develop its own status. Land customs disappeared. Such a measure was necessary for the Principality, now reduced to 1.5 sq.kms in size and an enclave in the "département des Alpes Maritimes", had become short on resources. The question of tapping new sources of wealth was a vital one. At that time was born the idea which was to become the image of the Principality — to start a place of gambling.

### Taxes abolished

A fantastic boom of high class tourism enabled the Prince's Treasury to increase its revenue constantly from royalties paid by the Casino and excises. On 8 February 1869, Prince Charles III issued a decree providing "as from this day land tax, income and occupancy taxes and business licence tax are hereby abolished".




1. The treaty of 17 July 1918 (incorporated into the Versailles treaty of 28 June 1919) is the basic instrument defining the relations between France and Monaco. On the other hand, the Principality qualifies as a sovereign State according to the general principles of international law. It complies with the requirements for sovereignty, namely a territory, a population, an organisational structure as defined in the Constitution of 17 December 1962. It is a recognised treaty-making power and is a member of several international organisations. The Common Market treaty of Rome, which provides that "this treaty shall apply to European territories for whose external relations a Member State is responsible", does not directly apply to Monaco for the Prince himself represents the Principality in its relations with foreign powers.

4 — Exemption from assessed taxation applied not only to capital and income of residents in the Principality but also to those of non-residents. Therefore, people who had their home or residence abroad, whatever their nationality, could invest capital in Monaco as well as Monegasque residents without being liable to any taxation.

In Europe, where wealth at that time still essentially consisted of real estate and prevention of tax avoidance was non-rexistent, such a privilege was not unusual. Only at the end of the nineteenth and the beginning of the twentieth centuries, did various tax reforms initiate a system to curb the excesses of those who were already being called tax dodgers.

### Treaty of 1918 — alignment with French interests

5 — It is the treaty of 1918, essentially designed to settle a dynastic question, which was, surprisingly enough, to determine the future fiscal relations between France and Monaco. Its preamble states that "the interests of the Principality of Monaco are necessarily bound — given its geographical situation — to those of France", and if "the Government of the French Republic undertakes to defend the independence and sovereignty of the Principality of Monaco and guarantees the integrity of its territory as if this territory were a part of France", for its part "the Government of H.S.H. the Prince of Monaco promises to use its rights of sovereignty in perfect conformity with the political and economic interests of France".

6 — Perfect conformity to French interests was to take effect immediately — in France the tax reform 1914-1917 had introduced the subject matter of tax assessment by way of actual rating and progressiveness in the computation of tax amounts. This reform, suddenly descending upon a society which had been used for a century to an utterly different method, was not well received by the French taxpayer — he considered the new powers of the tax authorities as an insufferable and ruthless measure against which he thought himself justified in resisting by concealment of profits. It was therefore necessary that a place of no taxation should not exist which would enable potential tax dodgers to find a haven to flout French tax laws. The particular agreements signed during the 1920's make remarkably clear the kind of broad constructions that the French Government intended to put on the treaty of 1918 in order to prevent people who resided or habitually lived in France from escaping taxation. Despite this new turn, relations between France and Monaco were still governed by the classic principles of liberal economy. As a consequence of the huge changes of the years 1939-1945, the French Government were to effect national recovery by methods inspired by planned economy. The interests of Monaco could less and less diverge from those of France.

### Financial agreements of 1945

7 — Among the financial agreements signed in 1945, the agreement on action against tax evasion had as some of its purposes the subjecting to tax in France of French citizens residing in Monaco, over a period of five years; levying a tax on business transactions carried out in France by people of any nationality residing in Monaco and consisting of the reselling of goods; granting French tax administration reinforced powers in the field of death duties; forcing the Principality to do away with favourable treatment to holding and bogus real estate companies.

This agreement is remarkable in that it virtually contained the principles which have governed the relations between the two countries since 1963. However given the unusual stringency of some of those measures, negotiations on particular points were conducted from 1945 to 1949 by an advisory committee on treaties. It was not until the last negotiations took place that the French Government reappraised its overall policy toward the Principality and relaxed some measures in the agreement. The need for combining several overlapping instruments into one made itself felt — the agreement of 23 December 1951 thereafter governed the relations between the two countries until a political crisis led to a show-down which resulted in the denunciation of most existing agreements to bring about new negotiations.

### The crisis

8 — It was in fact a personal clash superimposed on a background of arguments based upon tax equality and prevention of tax evasion which "led the French Government to observe that the Monegasque Administration was no longer acting in accordance with the basic instrument of relations between France and Monaco, not only in the political field but also in that of economy and taxation" [2].

As in the past, French demands invoked the preamble of the treaty of 1918 to ask for reconsideration of the Principality's special tax system in order to stop the "intolerable competition" of Monegasque companies, which was considered unfair to French companies, and to put an end to "srious tax avoidance".

9 — France did not use its right of requiring alterations in the agreement of 1951 and preferred unilateral denunciation of the agreements to negotiated alterations. Considering that the Principality's economic development was occurring at France's expense, the latter demanded a full fiscal alignment of the Principality as if it were a part of France.

Difficult negotiations extended over a period of more than a year during which the French Government took various intimidating and coercive measures which gave the conflict a tragi-comic dimension. Finally on 18 May 1963 a series af agreements were signed to define in an entirely new way the relations between the States. As far as the application of the fiscal agreement is concerned, the French tax administration unilaterally issued an important directive dated 17 July 1964. However, in practice, many special cases appear which are solved

2. Speech by *Michel Habib-Deloncle*, French Under Secretary of State for Foreign Affairs, at the "Assemblée Nationale", 25 July 1963.

by direct negotiation between the two countries or by a joint advisory committee convened on request from the parties to examine the questions of principles which may not have been settled through diplomatic channels and to expound a consistent doctrine. It should be noted that this agreement radically differs in its subject matter from the other international fiscal agreements concluded by France. As a matter of fact, it is not intended to do away with cases of double taxation but it aims to solve problems arising from differences in the burdens of taxation.

If the pressure that was brought to bear may be criticised, the events were in some way beneficial — "the 1962 crisis, like a lightening rod, diverted the possible consequences of the fact that some people may have regarded Monaco as a European haven. What was done would have been made inevitable by mere wisdom in the following years", *Mr. André Saint-Mleux*, Ministre d'Etat, told us.

### Present situation

10 — In the course of this short discussion, we shall deal with the strengthening by agreement or unilaterally of the laws of the Principality so that it would no longer be a haven, but would retain the advantages which are granted to certain individuals and companies, and we shall endeavour to establish that, notwithstanding possible minor specific adjustments, it is in the interest of both States that the present situation should endure. [3]

## II. ADJUSTMENTS BY AGREEMENT

11 — The adjustments are a result of the above agreement and of the agreements between the two countries describing the legal position of individuals and corporate bodies established in the Principality. Limitation to non-taxation of individuals — individuals of other than French nationality residing in Monaco — is kept outside the scope of the agreement. Such individuals would be subjected to French taxes only in those cases specified in the French laws on the territoriality of taxes.

### French nationals cannot escape French taxation by emigrating to Monaco

12 — This privilege, a vital one for the Principality, is indirectly confirmed by the agreement. Had it not been recognised, the immediate ruin of the tiny State and its prompt disappearance would have ensued. Finally, and with few exceptions, those French nationals who had been established on Monegasque territory since the end of 1957 were subjected to French income tax on their total world-wide income as though they were domiciled in France. Thus, contrary to a principle of international tax law, this agreement created a tax discrimination between two categories of residents according to their nationality. It should be mentioned that the checking of the actual situation of French people not taxable in France is rigorously carried out by Monegasque tax authorities — in fact, administrative collaboration is one of the fundamental provisions in the agreement. It is specified that the Monegasque tax administration will forward information to France either as a matter of routine or on request. Similarly, audits by French tax inspectors in the Principality are possible and Monegasque authorities are bound to give assistance in the collection of taxes.

13 — The creation of a tax on business profits was specified in the agreement. The Prince's Government was to raise, for the benefit of the Principality, a direct tax on business activities. For a long time, tourism ranked ahead of industrial development. Yet, starting in the 1950's, industry took an unprecedented turn upward. In spite of limited opportunities, many investors nonetheless choose the Principality because it was possible for them to carry on business activity practically free of tax. Parallel to local trades there appeared an export-oriented industry, a branch of which became perverted into organised malpractice with a view to evading all taxes on transactions not carried out in the Principality except *pro forma*.

### Introduction of a business profits tax

The new agreements changed business conditions radically by introducing — from 1963 onwards — a Monegasque direct tax levied at a rate of 35 percent on the profits of "enterprises" and companies whose foreign turnover is more than 25 percent of total turnover. Introduction of this tax was prescribed by section 1 of the Agreement of 1963; "Ordonnance Souveraine" of 19 March 1964 dealt with the specifics. It applies to all "enterprises", both individuals and companies, which carry on business activities in Monaco if at least 25 percent of their turnover results from operations which are conducted directly or indirectly, i.e. through an intermediary, outside Monaco.

14 — France wanted this text to be identical to the French corporate tax but had to admit from the begining that some of the French laws were impractical, for they would have threatened the very survival of the Principality's industrial activities. It was therefore agreed that "enterprises" whose local turnover is at least 75 percent would not be subject to tax. Outside of commodities, this tax exemption favoured the development of such luxury trade as jewels and works of art, etc. Most remarkable is the fact that famous jewellers and antique dealers have branches in Monaco, Sotheby Parke Bernet among others.

15 — The procedures for computation of the taxable base were initially copied from French regulations of the time, but evolution of the legislation in France and the problems peculiar to the Principality have created an ever widening gap so that the Monegasque business profit tax has developed characteristics of its own which make it distinctly different from the French company

3. We refer the reader to our works, as may be required:
— l'imposition en France des personnes physiques résidant en Principauté de Monaco (150 p.).
— l'impôt sur les bénéfices des entreprises et sociétés établies en Principauté de Monaco (115 p. + annexes).

In English, see: D.A. van Waardenburg, "Monaco: Some aspects of the tax system of a tax haven" in EUROPEAN TAXATION Vol. 16, July No. 7, 1976, p. 225 to 234.

tax. As a matter of fact, it is interesting to note that there is no provision in the agreement binding the Principality to catch up with the French legislation on direct taxes. There are also clear differences concerning depreciation, provisions and reserves, loss carry forward, dividends from subsidiaries, etc. But the most stringent provisions are no doubt those against concealment of profits: shifting of profits has always been a very important issue in the relations between the two countries, and the French Government took advantage of this conflict to forestall effectively all possible evasion, especially accommodation-payment, to people residing in Monaco.

**Shifting of profits henceforth counteracted**

16 — Where the shifting of profits is concerned, the agreement provides that, if the conditions of the commercial or financial relationship between a Monegasque enterprise (or company) and an individual person or legal entity resident or established abroad cannot be considered to be normal, the operations will be appropriately restated in the accounts of the Monegasque enterprise for purposes of the business profit tax or of any other tax, as the case may be. In order that these measures be put into effect, the agreement of 1963 provides that French tax authorities will forward to Monegasque tax authorities all information relevant to the assessment of tax. In this way, France is able to keep watch on Monegasque taxation processes.

17 — It should be noted that according to the French — Monegasque Conventions, French regulations on foreign currencies and investments apply in the Principality, which is of course situated in the Franc area. Thus, direct investments of foreign capital in Monaco are subject to prior authorisation from the Bank of France and from the French Division of the Treasury. [4]

## III. THE STRENGTHENING OF MONEGASQUE LEGISLATION

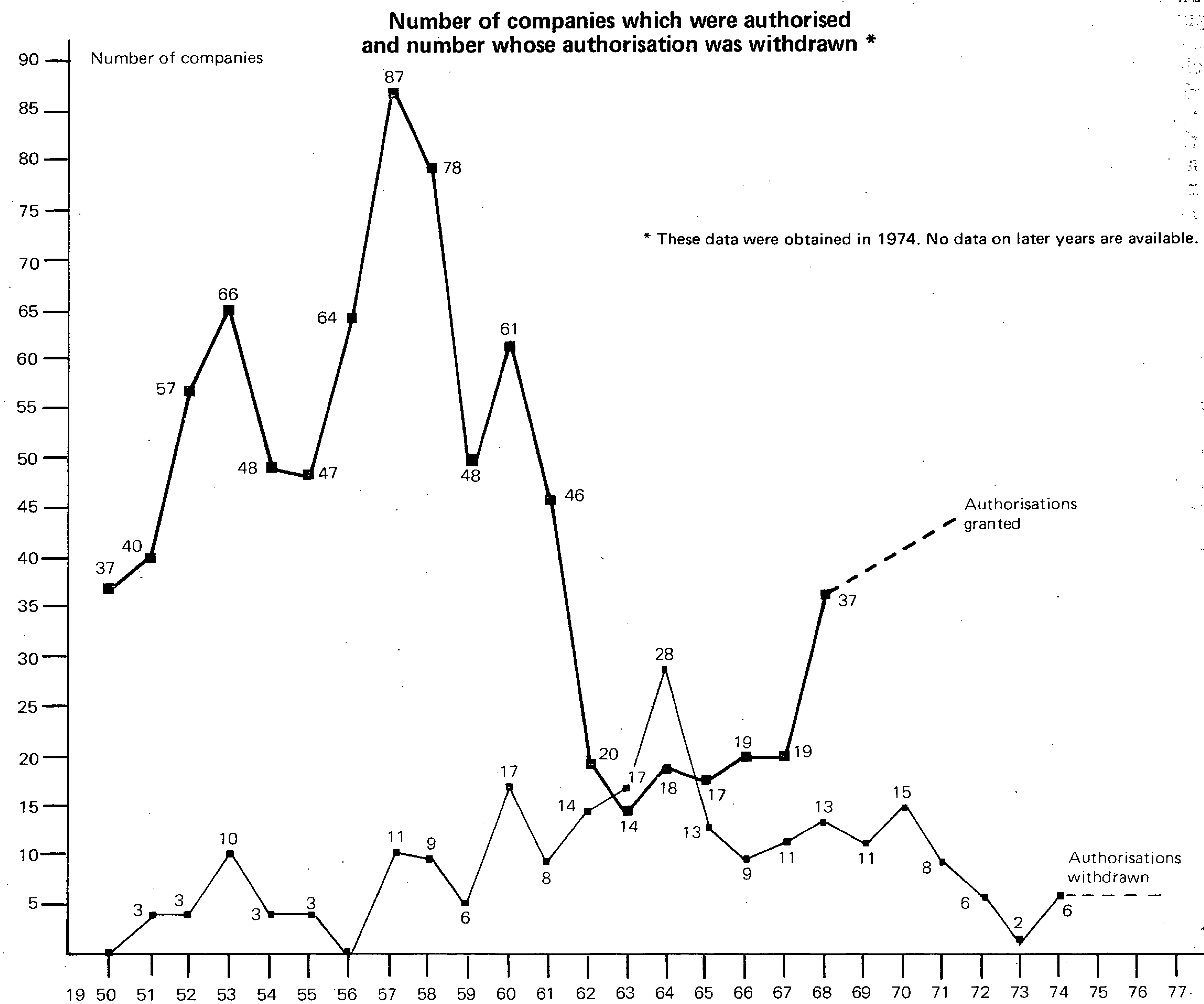
18 — In order to prevent any conflicts with France, the Principality itself makes sure no unwanted people take up residence on its territory by means of long established rules as well as measures to meet circumstances. As far as trading is concerned, strict regulations have long applied. Thus, according to the "Ordonnance" of 6 June 1867, a personal licence is required for any foreigner wishing to do business in the Principality. In the same way, any foreign company wishing to extend its activities to Monaco must be granted a licence for extension of activities. But it is for Monegasque companies that procedures are most complex. In addition to regulations copied from French law as regards notices, bookkeeping and bankruptcy, joint-stock companies can only be incorporated with Government consent and after approval of their charter. The Principality of Monaco is one of the few European countries where there remains in company law this prerequisite which was the rule up to the middle of the nineteenth century. And the obligation endures in a most rigorous form since the Administration may grant or deny consent at will. This in the first place is what is called "fait du prince" against which the promoter, once turned down, can institute no ultra vires action, the more so as no vested interests are at stake. One may wonder about the reason for such an authoritarian provision in an otherwise liberal regime. *Mr. J. Reymond*, a former member of the Government, told the "Conseil National" in December 1941: "the special position of the Principality, the need to keep out unscrupulous operators, the fear of uncommonly expert speculators flooding into the country and also the desire to abide by existing treaties have prompted us to adopt with regard to companies a cautious policy by introducing regulations making licences compulsory for individual traders". This authorisation means in fact approval of the future company for it will give it a legal title to existence by conferring upon it Monegasque nationality.

19 — Parallel to the authorisation of incorporation there is a procedure of withdrawal of the authorisation, which could always be used against foreign companies by reason of police regulations granted to the Administration by the "Ordonnance" of 1867. For Monegasque companies, the point was a moot one. As early as 1946, under French pressure, authorisations of incorporation of limited companies or real estate companies ("sociétés immobilières") granted after 1 September 1939 were reexamined by an *ad hoc* committee.
The way was open to the reversal of authorisations — the 1962 crisis was to bring about an aggravation of withdrawal conditions. In Article 4 of the Signature Protocol of the Agreement of 1963, it was stated that the Monegasque Government would undertake the strengthening of control on limited companies, especially through a reform of the rules of incorporation and management of those companies.
Under Law No. 767 of 8 July 1964 the authorisation granted for incorporation of a company can be withdrawn by the Government, for instance when the company has had no apparent activity in keeping with the purposes stated in its charter for more than two years and has had no reasonable motive, or when it has made no use on Monegasque territory of business premises and staff necessary to carry out normal activities under its charter.
However in order to limit the Government's discretionary powers in the matter, the advice of a special committee is required. This committee is fully empowered to examine and investigate cases. Companies declared unauthorised shall go into liquidation. One can observe from Chart I on the following page an obvious increase in the number of withdrawals following the law and a reverse trend up to 1968 in the number of applications for authorisations of incorporations.

20 — Among the measures to strenghten legislation, one should also mention control on "sociétés civiles"

4. French exchange regulations are based upon the distinction between "residents" (with a further distinction between French and foreigners) and "non-residents" abroad (regardless of nationality). By "abroad" is meant all countries except France, Corsica, Monaco, French overseas "départements" (D.O.M.) and the Franc area nations.

## CHART I




through creation in 1966 of a special register listing all companies.

But there are also purely temporary measures by which the Prince's Government intends to limit the development of certain types of activities. A few instances are the Government decision in late 1976 to raise the minimum capital of limited companies from 100,000 F to 250,000 F at the time of incorporation for new corporations or on any rectification of the articles for existing onces; a reluctance to allow retail activities to be carried out under the legal form of limited companies; the fact that international headquarters of foreign companies are not as welcome as they used to be. In the same way, whereas complete commercial cycles taking place outside Monaco still are excluded from the Monegasque business profits tax, Tax Authorities have just set down two conditions for this exclusion — that those dealings shall be clearly apart from activities defined in the charter and that they shall be of a regular nature.

## IV. MONACO'S EVER-ATTRACTIVE LEGISLATION

21 — As we now know, agreements with France have regulated business activities in Monaco in perfect conformity with France's interests. Nevertheless, the Principality maintains several attractive advantages for foreign investors and prospective residents, both legally and fiscally.

### 1. The opportunity of establishing trusts

22 — Individuals, who under their own legal status have the possibility of arranging their personal affairs by means of a trust during their lifetime or after death, may do so in the Principality with the assistance and support of local institutions. Monegasque Law No. 214 of 1936 modifying Law No. 207 of 1935 regarding trusts is of particular interest to those who are domiciled in Monaco and whom their national law [5] entitles

5. This law interests primarily British and American citizens.

to establish trusts, as it provides them with a means of avoiding the rules concerning the compulsory reserves regarding their heirs under the Monegasque succession laws. The essential conditions for the establishment of such a trust are as follows:
- the trust deed must be executed in Monegasque "notarial" form;
- the trustees must be selected from a list drawn up and maintained by the Court in Monaco (one trustee must be a trust corporation but a personal co-trustee may be added — see Article 3);
- a certificate drawn up by an approved lawyer of the country in question stating the validity of the trust dispositions under the relevant foreign law (see Article 2) must be annexed to the trust deed.

## 2. An independent economic policy

23 — The historical and socio-political situation of Monaco and France accounts for the fact that the laws of the Principality and French legislation are often very close in spirit as well as in their general outline, and especially so with regards to company law.

24 — *Company law.* The location of the registered office is the only possible criterion for Monaco in order to determine the nationality of companies. Unlike French law, the legal distinction with regard to form between "sociétés civiles" and trading companies does not apply: the nature of a company depends on its object. Private companies are not subject to Government authorisation for incorporation. When foreigners are involved, they must have a personal licence according to the 1867 "Ordonnance". Two kinds of joint-stock companies are allowed to operate in the Principality: corporations ("sociétés anonymes") and limited partnerships which have issued shares ("sociétés en commandite par actions"). However, no such limited partnerships exist due to the fact that their administration is possibly more complicated that that of corporations. In addition to the Government consent already discussed, corporations must comply witht he following regulations:
- the charter shall be drawn up by a Monegasque contract lawyer ("notaire");
- the capital shall not be less than 250,000 Francs according to strict regulations (By-law of September 1976). At the time of incorporation, the capital shall be fully subscribed and a quarter at least of such capital shall be effectively paid up;
- shares of all types (cash, vendor's or founder's shares and bonds) must be effectively issued;
- theoretically, two people can form a company;
- there is no restriction regarding the nationality of the founders or that of the directors, provided the usual procedure is followed; [6]
- the chairman of the board or managing director should preferably be a resident of the Principality;
- the company is required to appoint one or several auditors who shall be selected from the Chartered Accountants registered with their association in the Principality;
- the company charter has to be published in the "Journal de Monaco".

25 — As for the "Société civile monégasque", the clause governing this type of company requires:
- the drawing up of a deed subject to registration within one month;
- the transfer of shares or stocks to be in the form of a written agreement registered within one month under penalty of invalidation;
- the registration of the company within two months following its incorporation in a register foreseen to that effect;
- the incorporation requires at least two partners regardless of nationality and residence; the management may be assumed by a resident of Monaco, again regardless of nationality;
- the head office must be set up in Monaco.

Companies of this type, when incorporated for the purpose of managing personal assets, are not bound to submit their books.

26 — New regrouping formulas have been originated due to the particular nature of the activities of companies in Monaco, namely:
- the non-profit organisation (Law No. 492 of 3 July 1949) allows the regrouping of various branches of trade in the pursuit of common interests with regard to Monegasque administration or in the matter of export inducements.
- the "group of common economic interest" (Law No. 879 of 26 February 1970) or "Groupement d'intérêt économique" helps in obtaining credit thanks to common purchasing of, for example, maintenance products.

27 — *Government incentives.* At present, the Government of Monaco is interested in attracting business and manufacturing enterprises of solid reputation. As a general rule, such enterprises should meet the following criteria: no heavy machinery, no pollution, no noise, highly qualified workers and executives, small space requirements and a high added value factor.
The current forms of foreign investment in the national economy are:
- participation in existing companies;
- establishment of administrative headquarters, managing departments or service branches of foreign companies;
- incorporation of commercial companies.

Because of the recent influx of companies and residents, the housing situation is critical, in spite of considerable building activity. Enterprises of administrative character, however, have been able to satisfy their requirements in private apartment buildings; a number of commercial and industrial buildings are under construction or in an advanced planning stage.
A new area ("Fontvieille"), reclaimed from the sea, will shortly become available for commercial and industrial development. Within the framework of the urban development plan, now under study, it will be possible to in-

6. In particular: justification of assignment of capital whenever the investor's Government requires, depending on the Exchange Control Regulations in force at the time.

vest in commercial properties under a land-leasing arrangement or by outright sale from the Government. [7]

### 3. Some tax advantages

28 — As for taxation, the major advantage is that no individual income tax is levied on any nationals except certain French citizens. Foreigners who transfer their residence from France to Monaco are no longer liable to French tax on income arising at a later date, no particular length of stay being required. But how does one establish "residence" in Monaco? Any foreigner wanting to establish residence in Monaco must obtain a visa from the French Consul of his place of residence. Once the visa is obtained, he must apply for an identity card at the "Sûreté Publique Monégasque", with attached documents showing that he has a residence in Monaco, either as tenant or as owner, and that he has a professional activity or, failing that, sufficient means of subsistence.

**Foreigners are exempt from Monegasque income tax: mind the rules for residence application!**

As "temporary resident", he will then receive a one year identity card renewable under certain conditions; after ten years of "provisional" residence, he will be given a "privileged resident" card valid for ten more years. The cards are renewed provided the foreigner actually lives in Monaco for at least six months per year. This is only the application of the "Convention de voisinage" of 18 May 1963, in particular of chapter one: "admittance, stay and establishment of foreigners". [8] These rules are more or less measures of self-discipline.

**CHART 2**

**Registration Taxes**

(see in particular:
Law No. 580 of 23 July 1953)

| | | |
|---|---|---|
| 1. *Transfer Taxes* | | |
| a) transfer for valuable consideration | | |
| — transfer of goodwill | | 7.5% |
| — transfer of lease | | 1 % |
| — sale of shares | | 1 % |
| — sale of shares of "sociétés civiles" (estates based in Monaco) | | 6.5% |
| — transfer of negotiable bills | | 1 % |
| — sale of estates located abroad | | 5.00 Francs |
| — sale of estates located in Monaco | | 7.5% |
| b) Transfer by deed-poll (gift taxes and death duties) — (see text) | | |
| 2. *Other Registration Fees* | | |
| — incorporation of a company | | 1 % |
| — tax on issuance of shares | | 0.5% |
| — tax on issuance of bonds | | 0.5% |
| — lease of movables | with indefinite term | 5 % |
| — lease of immovable property | with indefinite term | 6.5% |
| — leases with a definite term | | 1 % |

29 — *Registration fees* are highly favourable. Such duties befall only the assets located in the monegasque territory and acts drawn up in the Principality. As in the entire Monegasque legislation, the texts have not been seriously classified: various "ordonnances" and laws complete and amend each other.
These duties, flat rate or progressive scale, are levied at registration in the instances shown in Chart 2.

30 — We wish to point out two particular instances:
— *Inheritance tax* — When a citizen of Monaco or of France (who had resided for at least five years in the Principality) dies, all his Monaco based assets without exception and all his assets in France except real-estate, goodwill and shares of commercial firms (other than public limited companies) are subject to the inheritance tax of the Principality of Monaco according to the scale below. [9] As far as foreigners are concerned, i.e. persons that have neither the nationality of Monaco nor that of France, only the Monaco based assets at the date of death are subject to the tax of the Principality, whether these persons were residents or non-residents of Monaco.
Under Law No. 276 of 20 October 1939 as amended on 1 June 1961, "the net portion in transfers by death of personal or real-estate property or usufruct, including foreign securities of whatever nature to which each heir is entitled, is subject to the following duties:

| | |
|---|---|
| — direct heirs (or grandchildren if the children are dead) | 0% |
| — between husband and wife | 0% |
| — between brothers and sisters | 8% |
| — between uncles and aunts, nephews or nieces and grand-children (when the children are alive) | 10% |
| — between collaterals other than brothers or sisters, uncles or aunts, nephews or nieces. | 13% |
| — between individuals without kinship | 16% |

—

— *Incorporation charges* represent approximately 4% of the capital;
i) *registration fees:* company charters as well as proceedings required in case of increase in capital are liable to a registration fee of 1%. Also, shares and share certificates, paid up or not, are subject to a stamp duty amounting to 0.50% of their nominal value.
ii) *legal fees:* currently applicable rates for legal fees are as follows, regardless of the type of company:

| | |
|---|---|
| • for capital up to 10,000 Francs | 1.80% |
| • for capital ranging between 10,000 and 20,000 Francs | 1.30% |
| • for capital above 20,000 Francs | 0.90% |

7. Other opportunities also exist in the commercial market. The Government is prepared to assist prospective space seekers in making relevant contacts with private real estate or rental agencies.
8. Art. 4, 2nd and 3rd paragraphs: "the Government of the Prince binds itself to consult French authorities on any application dealing with any change in the nature of activities of a foreigner established in Monaco — the Government of the Prince binds itself to take into consideration any remarks or objection regarding the foreigner's personal activities.
9. A double taxation agreement was reached between France and Monaco on 1 April 1950.

iii) *cost of publicity:* the cost of publication of the charter in the "Journal de Monaco" is, at the present rate, 2.50 Francs per line, and ranges between approximately 1,500 and 2,000 Francs.

31 — *Fiscal provisions for trusts* are as follows: the deed creating or transferring trusts within the Principality is subject to proportional registration duties which vary according to the number of beneficiaries succeeding in the trust = 1.30 percent for one beneficiary, 1.50 percent for two beneficiaries and 1.70 percent for more than two beneficiaries.
This duty is converted into an annual tax of 0.20 percent if the parties elect to do so in the deed constituting the trust.
The duty or tax is collected in lieu of all gift taxes or death duties. In either case, the tax is assessed on the total amount of the value of the estate invested in the trust, with the exception of Monegasque securities (subject to a reduced proportional duty).



32 — The *Monegasque business profit tax rate* is the result of the following developments: this tax was initially levied at a flat rate of 25 percent when it was introduced in 1963. The rate for 1964 was 30 percent, and for 1965 it was 35 percent. The agreement provided that the rate would be further increased to 40 percent for 1966 and later years, subsequent to government talks. However, it was decided that, until further notice, the rate would remain at 35 percent. Finally it depends on French fiscal policy whether or not another rate will come into effect.

33 — The particular taxation concerning administrative headquarters, i.e. usually 35 percent on 8 percent of running expenses (which amounts to a 2.8 percent tax rate), is not necessarily an advantage for those offices that do not have precise bookkeeping allowing an exact result to be determined; firstly because this 8 percent is in fact susceptible to a variation between 8 and 15 percent as is the case in the "Quartiers géneraux internationaux" in France; also because offices with precise bookkeeping may turn out to be either liable to a lower sum or not even taxable.

## V. CONCLUSION

34 — It now remains to be seen what the future holds regarding the French — Monegasque relationship. According to Mr. Saint-Mleux, "presently, all the requirements for a happy co-existence in the various fields covered in the French — Monegasque Agreements are at hand".

35 — The promotion in May 1977 of the Monegasque legation in Paris to the rank of Embassy clearly shows, from the point of view of Protocol, the privileged relations thus reaffirmed in the eyes of the international community.

36 — One may, however, express concern over the internal development of French taxation. Indeed, there is a movement in France favouring the increase of Revenue arising from direct tax and the decrease of the indirect tax yield — mainly the "unfair" V.A.T. A new left wing majority in Parliament in March 1978 could accentuate this tendency. Such developments would affect the Budget of the Principality: when examining this Budget, it appears that the amount of revenue receipts from turnover taxes accounts for almost half the total intake.
This amount, a result of a formula stipulated in the Tax Agreement of 18 May 1963, [10] could therefore decrease.

37 — However, the increase of the intake from real estate tax could countervail the aforementioned decrease as numerous foreigners will continue to invest in the Principality. The absence of taxation regarding for-

10. Art. 15: "the taxes on turnover in the Principality are levied on the same basis and at the same rates as in France". The formula concerning the splitting up ("compte de partage") between France and Monaco of the turnover tax yield is dealt with in Article 17.

eigners (other than French nationals) is therefore a fundamental advantage for Monaco. No Monegasque income tax is foreseen for individuals. There is no talk of increasing the rate of the Monegasque business profit tax either.

In the final analysis, and in the terms used by the Minister of State in the interview he kindly accorded us: "the future will bring no change: the Principality will remain liberal and welcoming".

## CHART 3

### Revenue of the Principality of Monaco

#### A. COMPARISON OF REVENUE DERIVED IN 1975 AND 1976

| | 1975 in Frs. | 1976 in Frs. | 1976/1975 Differential in % |
|---|---|---|---|
| CHAPTER I | | | |
| Private property | 6,753,573.83 | 6,705,530.13 | – 0.71 |
| State monopolies | 66,447,613.72 | 79,602,589.15 | + 19.79 |
| tobacco monopoly | 13,033,256.51 | 13,881,573.31 | + 6.50 |
| telephone board | 27,288,365.63 | 35,766,786.31 | + 31.06 |
| general post-office | 11,481,576.79 | 16,746,048.07 | + 45.85 |
| stamp office | 14,193,780.53 | 12,684,343.41 | – 10.63 |
| official published works | 450,634.26 | 523,838.05 | + 16.24 |
| Granted monopolies (under contract) | 19,454,168.72 | 23,752,857.33 | + 22.09 |
| "Sociétés des Bains de Mer" | 12,631,836.03 | 13,168,284.87 | – 3.66 |
| Others | 6,822,332.69 | 11,584,572.46 | + 69.80 |
| Financial sector | 13,575,088.47 | 14,449,546.90 | + 6.44 |
| CHAPTER II | | | |
| Yield from administrative departments | 2,698,721.08 | 3,172,618.30 | + 17.56 |
| CHAPTER III | | | |
| Taxes | 253,295,914.91 | 375,993,320.62 | + 48.44 |
| lump sum yield from custom duties | 17,723,617.00 | 18,694,406.00 | + 5.47 |
| taxes on private transactions | 24,744,601.44 | 33,542,124.15 | + 35.55 |
| taxes on turnover | 175,161,696.80 | 290,851,626.70 | + 66.04 |
| excise duties | 1,600,311.66 | 2,079,288.70 | + 29.93 |
| business profits tax | 34,065,688.01 | 30,825,875.07 | – 9.51 |
| Total (excluding Fontvieille) | 362,225,080.73 | 503,676,462.43 | + 39.05 |
| Fontvieille | 64,379,000.00 | 24,570,000.00 | – 61.83 |
| TOTAL GENERAL | 426,604,080.73 | 528,246,462.43 | + 23.82 |

#### B. DISTRIBUTION OF REVENUE

| | Amount | % on tax revenues |
|---|---|---|
| Tax on turnover (including V.A.T.) | 290,851,626.70 | 55.06 |
| Business profits tax | 30,825,875.07 | 5.84 |
| Custom duties | 18,694,406.00 | 3.54 |
| Taxes on private transactions | 33,542,124.15 | 6.35 |
| State monopolies | 79,602,589.15 | 15.07 |
| Granted monopolies | 23,752,857.33 | 4.49 |
| Financial sector | 14,449,546.90 | 2.73 |
| Other normal income | 11,957,437.13 | 2.26 |
| Fontvieille | 24,570,000.00 | 4.66 |
| TOTAL GENERAL | 528,246,462.43 | – |

#### C. BUSINESS PROFITS TAX

In 1976, the business profits tax yield reached an amount of 30,825,875 Frs., compared with 88,073,928 Frs. taxable sales, reflecting a reduction of 9.51 percent compared with the previous period.

In fact these results reflect the 1975 situation, as the business profits tax is collected with a twelve months gap.

For the last five years, the tax yield fluctuated as follows:

| | |
|---|---|
| 1972 | 26,655,522 Frs. |
| 1973 | 24,489,039 Frs. |
| 1974 | 29,310,689 Frs. |
| 1975 | 34,065,688 Frs. |
| 1976 | 30,825,875 Frs. |

Taking the rate of fluctuation into consideration:

| | 1963 | 1973 | 1974 | 1975 | 1976 |
|---|---|---|---|---|---|
| Rate | 25% | 35% | 35% | 35% | 35% |
| Rate index | 100 | 140 | 140 | 140 | 140 |
| Revenue index | 100 | 289.24 | 335.48 | 292.69 | 339.33 |
| Revenue index adjusted for rate fluctuations | 100 | 206.60 | 239.62 | 209.06 | 242.37 |
| Annual fluctuation | – | – | + 15.98% | – 12.75% | + 15.93% |

# French Withholding Tax on Employment Income

## THE NEW WITHHOLDING TAX ON WAGES PAID TO NON-DOMICILIARIES AND TAXATION OF WAGE PAYMENT FOR FOREIGN ACTIVITIES (Law No. 76 - 1,234 of December 29, 1976)

by Patrick Michaud * and Michel Saillant **

*On July 1, 1976 the French Government submitted a Bill to Parliament which not only introduced a new concept of domicile for purposes of individual income tax, and succession duties but which also made significant changes in the taxation of domiciled and non-domiciled individuals. One of these changes which will, inter alia, be discussed in this article is the introduction of a withholding tax on non-domiciled wage earners. The Bill was enacted as Law of December 29, 1976 and the essentials of the new tax are to be found in Art. 12, thereof.*

## Table of Contents



## I. SYSTEM OF TAXATION

Wages paid by a French company to a wage earner domiciled abroad constitute French-source income. Two cases can be distinguished.

A. In cases other than those covered by a tax treaty the income derived from professional activities whether salaried or not is taxable in France if the activity is carried out in France (Law, Art. 5(d)). In this case, therefore, we are dealing with French source income.
The text of the Law provides that the taxable income of such taxpayers is determined in conformity with the same rules which apply to income of a similar nature earned by persons domiciled in France. However, the tax cannot be less than 25 percent of the taxable income (Law, Art. 4).

B. In cases which are covered by a tax treaty (Art. 15 of the O.E.C.D. Model Convention) income is taxable in the State in which the person is resident and in principle no tax will be withheld by the country from where the salary is paid. However, where the activities are carried out in the other Contracting State the income will be taxable in the latter State.

## II. WITHHOLDING TAX ON WAGES PAID TO NON-FRENCH CITIZENS DOMICILED ABROAD (LAW ART. 12)

As of January 1, 1977 income tax will be withheld on salaries, pensions, life annuities and similar payments of French origin, paid to persons not domiciled in France.

The taxable base of this withholding tax is the total net amount of the sums paid, determined in conformity with the rules which apply for individual income tax purposes. However, only the fixed deductions may be applied and no allowance for actual expenses connected with the activities is given. Therefore the non-domiciled recipient may only deduct the general 20 percent deduction and the 10 percent expense deductions for salaries.

The withholding tax is computed according to the following graduated rate scale which applies to income derived during the calendar year:

| *Portion of sums subject to withholding tax* | *Rate* |
|---|---|
| Up to 20,000 Fr.Frs | 0% |
| From 20,000 - 60,000 Fr.Frs. | 15% |
| In excess of 60,000 Fr.Frs. | 25% |

The Government may issue decrees which adjust the brackets if the income relates to a period of time other than that of a year.


* Ancien élève de l'Ecole Nationale des Impôts, Avocat à la Cour d'Appel.
** Ancien élève de l'Ecole Nationale des Impôts, Consultant.

The 15 percent and 25 percent rates mentioned above are reduced to 10 percent and 18 percent respectively in the overseas departments (départements d'outre mer or D.O.M.). The withholding tax may be credited against the income tax which is due on the income from wages.

Numerous wage earners normally living abroad (artists, show business people, seasonal workers) whose activities in France are of short duration frequently neglect upon return to their home country to pay to the French Treasury the taxes due on their French earnings. Despite the agreements concluded with certain countries it is often very difficult to enforce these taxes. The introduction of a withholding tax on the income derived from salaries, pensions and life annuities enables the French tax authorities to curb this kind of tax evasion.

The withholding must be made according to the graduated rate scale given above but may be credited against French individual income tax on the taxpayer's total French-source income. However, the withholding tax is a final tax for French nationals domiciled abroad in respect of that part of their salaries and pensions which is lower than 60,000 Fr.Frs.

## III. TAX TREATMENT OF SALARIES PAID TO FRENCH NATIONALS

### A. Treatment of French nationals not domiciled in France

As far as that part of net taxable income not exceeding 60,000 Fr.Frs. is concerned which consists of French-source salaries, pensions, life annuities and similar payments paid to French citizens not domiciled in France the individual income tax — which normally may not be less than 25 percent in the case of non-domiciliary — may not exceed the amount of the withholding tax due. In addition, this income is not included in total income for the computation of the individual income tax of the non-domiciliary's taxable French-source income.

As stated above, Art. 5 of the Law provides that French-source income which is subject to individual income tax will be taxed at a minimum rate of 25 percent even in those cases where the application of the normal rates would have resulted in a lower tax.

However, for salaried workers and pensioners who possess French nationality, the minimum tax equals the amount of the withholding tax imposed. In this way, these taxpayers benefit from a full exemption for their taxable income up to 20,000 Fr.Frs. and from a reduced rate of tax (15 percent) for the next 40,000 Fr.Frs. In addition, for the purposes of computation of the rates of the progressive income tax on the remainder of the taxpayer's income only that part which exceeds 60,000 Fr.Frs is taken into consideration.

### B. Treatment of French nationals domiciled in France and working abroad

Salaries paid to French nationals who are domiciled in France and who are sent abroad by an employer established in France are not subject to income tax in the following cases:

1. Salaries paid to French citizens for their activities abroad (for their assignments abroad) are exempt from income tax if:
   - the taxpayer can prove that the income has effectively been subject to tax in the country where the activity is carried out;
   - and that the foreign tax is equal to at least two thirds of the income tax he would have had to pay in France on the same taxable base.
2. Salaries paid to French citizens domiciled in France and on an assignment abroad are exempt from French individual income tax:
   - if they can prove that they carry on activities abroad lasting for more than 183 days in any period of 12 consecutive months;
   - and if the income is derived from one of the following activities carried on abroad:
     i) construction site or assembly project, setting up of industrial complexes, their running and their exploitation and the prospecting and engineering connected with these activities;
     ii) prospecting, research or extracting of natural resources.

It is immaterial whether the salary has been taxed abroad or not.

3. In all circumstances where the taxpayer is unable to benefit from the above exemptions, only so much of the income will be taxed in France as would have been received if the activity had been carried out in France.
4. Where the taxpayer benefits from one of the above exemptions the tax on his other French-source income is computed at the rate corresponding to the taxpayer's total income, whether exempted or not.

## IV. APPLICATION OF FOREIGN TAX TREATIES

The new tax treatment does not apply if a tax treaty provides for a different form of taxation or of a division of the right to impose tax between the Contracting States.
In this respect it is important to note that tax treaties take precedence over (French) national law and most tax treaties provide for non-discrimination rules under which equal treatment must be granted to French nationals and nationals of the Contracting State involved.

## V. APPLICATION OF THE NEW PROVISIONS

### A. In general

*1. Scope of the withholding tax*

In those cases where there are no tax treaties providing otherwise, salaries, pensions, life annuities and similar

payments from French sources [1] paid to persons who are not domiciled in France for income tax purposes are subject to the withholding tax.
The following persons are considered to be domiciled in France:
- those persons who have their home in France or spend most their time in that country;
- those persons who carry out a professional activity in France, whether salaried or not, unless they can prove that this activity is carried out on an accessory basis;
- those persons who have the centre of their economic interests in France.

Civil servants who carry out their duties or who are charged with a mission in a foreign country and whose income is not subject to income tax in that country are also considered to have their fiscal domicile in France.

*2. Influence of international tax treaties*

With respect to salaries the provisions of international tax treaties do not, in principle, prevent tax being deducted at source. However, there are some exceptions to this rule, in particular:
- no tax may be withheld on salaries paid to frontier workers who have their fiscal domicile in Belgium, Germany, Spain and Switzerland (with the exception of the canton of Geneva);
- international tax treaties have special provisions which should be consulted when necessary, which govern payments made to teachers, students as well as wage earners carrying out their activities on board a ship or aircraft in international traffic;
- numerous tax treaties provide that no tax is to be withheld on French-source public payments made to a person who possesses the nationality of the Contracting State in which the person has his fiscal domicile;
- in our opinion no tax may be withheld if the salary has been paid in respect of work carried out abroad.

With respect to pensions and life annuities tax treaties do not usually allow for tax being withheld at the time of payment except in the case of those recipients who have their fiscal domicile in Italy or Canada. Furthermore, certain international tax treaties contain special provisions which should be consulted where necessary. However, international tax treaties do not prevent tax being withheld on pensions or public annuities except where the recipients have their fiscal domicile in one of the following countries: Algeria, Bénin, Cameroon, Central African Empire, Congo, Ivory Coast, Gabon, Upper Volta, Mali, Madagascar, Senegal, Togo or Tunisia. No tax is withheld from pensions and public annuities paid to recipients domiciled in one of these countries.

*3. Base of the withholding tax*

Tax is in principle, withheld on the gross amount of the payments discussed in this article. However, as in the case of the individual income tax, tax is withheld on the amount of salaries, wages, pensions and life annuities (i.e. after deduction of expenses actually incurred). Consequently, when computing the taxable amount it is necessary to take into account not only the lump sum deduction of 10 percent for expenses and supplementary deductions for the profession in question, where applicable, but also the special deduction of 20 percent provided for by Art. 158(5) of the General Tax Code (Code général des impôts).

Pensions and annuities which have been acquired for no consideration also benefit from the 20 percent deduction. The base for annuities which have been acquired for valuable consideration is computed in conformity with the provisions of Art. 158(6), i.e. only part of the annuity is subject to the tax, 80 percent of that part which exceeds 22,000 Fr.Frs. per year must be included in the taxable base, if necessary this amount should be adjusted where shorter periods of time are involved e.g. 5,500 Fr.Frs. for a quarter, to 1,834 Fr.Frs. for a month or to 71 Fr.Frs. for a day.

*4. Rate of withholding tax*

The tax withheld on salaries, pensions and life annuities is computed according to the following table which reflects the duration of the activity or the period of time corresponding to the payment.

| Duration of the activity or of the period corresponding to the payment | Rate of 0% | Rate of 15% | Rate of 25% |
|---|---|---|---|
| | Portion of the net amount subject to deduction (less than) | Portion of the net amount subject to deduction (from - to) | Portion of the net amount subject to deduction (more than) |
| Year | 20,000 F | 20,000 to 60,000 F | 60,000 F |
| Quarter | 5,000 F | 5,000 to 15,000 F | 15,000 F |
| Month | 1,667 F | 1,667 to 5,000 F | 5,000 F |
| Week | 65 F | 65 to 193 F | 193 F |
| Day or fraction of a day | 65 F | 65 to 193 F | 193 F |

The rates of 15 percent and 25 percent are brought down to 10 percent and 18 percent when the debtor is resident in the overseas departments (D.O.M.).

When the duration of the activity or the period corresponding to the payment differs from the above categories, it must be calculated in proportion to the number of days. For the purposes of this calculation, each complete month is counted as 26 days and each complete week as 6 days.

## B. Payment of the tax withheld to the Treasury

Taxes withheld for any given month should be paid within the first two weeks of the following month to the revenue office (recette des impôts) (and not to the "Treasury Accountant" (comptable du Trésor) as in the case with the withholding taxes referred to in Articles 105-107 of the General Tax Code) nearest to the residence or the head office of the party that is making the payment.

1. Are considered as such: (i) salaries originating from an activity carried out in France and (ii) pensions and life annuities paid by a debtor established in France.

The payment should be accompanied by a declaration in duplicate, a copy of which is enclosed.

The annual declaration of salaries, pensions, life annuities, fees and other income should be altered so as to show not only the net amount paid but also the withholding tax which has been deducted.

### C. Penalties

*1. Failure to pay, late payment or insufficient payment of the tax withheld*

In these cases the debtor is subject to:
- either the penalty for late payment as provided for in Article 1727 of the General Income Tax Code if it is accepted that he has acted in good faith (3 percent for the first month and 1 percent for each subsequent month); or
- the fiscal fine provided for in Article 1731 of the above Code in all other cases.

*2. Failure to withhold tax*

Every debtor who has failed to withhold tax on the income or who has withheld too small an amount will be subject to a fine which equals the amount of non-withheld tax (Article 1768 General Tax Code).

### D. Finalization of the tax position of the recipient

The withholding tax introduced by Article 12 replaces the individual income tax for that part of taxable wages, salaries, pensions and annuities which does not exceed 60,000 Fr.Frs. Thus, this part is not taken into account for the computation of the individual income tax and the pertinent withholding tax is not creditable. However, that part of the wages and salaries which exceeds 60,000 Fr.Frs. is included in the taxable base for individual income tax purposes and the corresponding withholding tax is creditable.
The steps necessary to achieve this finalization are taken by means of assessment.

## U.S. Oil Companies and the Foreign Tax Credit

*U.S. individual and corporate taxpayers who pay a foreign tax on their foreign-source income are entitled to credit the foreign tax against the U.S. income tax computed on this income. However, Sec. 901 of the Internal Revenue Code provides that in order to qualify for the foreign tax credit the foreign tax must be an income tax, war profits or excess profits tax. It is often difficult to determine whether a foreign tax is covered by the above definition. Recently problems have arisen with respect to royalties paid by U.S. oil companies which have often been treated as if they were de facto income taxes. However, the U.S. Treasury has now informed an oil workers' union that it will no longer grant the foreign tax credit with respect to oil taxes imposed by Libya and Saudi Arabia. The new policy will apply with respect to taxable years beginning on or after June 30, 1978. (DOC. 78 - 1118)*

# IRELAND:

# Budget 1978

*On February 1, 1978 the Irish Minister for Finance, Mr. Colley, pronounced his Budget Statement of which extracts pertaining to his tax proposals are reproduced below.*

### I. PERSONAL INCOME TAX

I now come to my proposals for changes in the personal income tax. I have already indicated that the increases in the main personal income tax allowances proposed in the manifesto would be sufficient to improve real disposable incomes significantly, taken in conjunction with the Government target of a wage increase of about 5%. I propose to increase the single allowance by £200, from £665 to £865, and to increase the married allowance by £630, from £1,100 to £1,730.

At its new rate of £1,730, the married allowance will be double the single allowance. The existing allowance of £230 for working wives will be maintained. These measures should be of particular benefit to married couples. Combined with a pay increase of 5%, this would give an increase in weekly after-tax income of £6.52, or 11%, for a married man with two children who is on average industrial earnings of about £70 a week.

The abolition of rates on domestic dwellings and the abolition of motor vehicle duties for all but large cars will also mean a good deal more cash in the pocket for the average family in 1978. Savings in motor vehicle duties for a modest family saloon should work out at about £1 a week. Rates savings will, of course, depend on the type of accommodation which a family has. The average savings here should be about £2 a week for a local authority tenant; for a family purchasing a three-bedroomed semi-detached house in the Dublin area, the saving could be £4 a week or more.

All in all, therefore, the average family can expect to be at least £9 to £10 a week better off in terms of disposable income by virtue of these particular measures.

In line with the increase in the single allowance which I have mentioned, the personal allowance for widows and widowers will go up from the present level of £735 to £935 — that is an increase of £200.

I have never accepted the view that all pensioners should be automatically exempt from tax, regardless of their income. I feel that the best way to tackle the tax burden of pensioners is to increase the special age allowance available to persons aged 65 years or over, and this I propose to do. The existing age allowances of £45 for single or widowed persons and £145 for married persons are to be increased by £35 in each case, that is to £80 and £180, respectively. Taken in conjunction with the other increased allowances which I have announced, this will result in a significant improvement in the position of pensioners who are paying income tax.

The cost of all these increases in personal allowances will be £63.4 million this year.

The Finance Bill will contain a provision to exempt from income tax the interest derived by thalidomide children from the investment of the lump-sum awards received by them. This exemption will be in line with the exemption already accorded the monthly payments to these children.

The cost will be about £5,000 in 1978.

Under present legislation, premiums paid by self-employed persons to secure a retirement annuity qualify for income tax relief. There is, however, a limitation on qualifying premiums of 15% of net relevant earnings or £2,000 whichever is the less. It has been represented to me that, in view of the percentage limitation, the retention of the cash limitation is inappropriate.

I have accepted this viewpoint and propose accordingly to abolish the cash limitation. The 15% limitation, which is in line with that applicable to superannuation contributions for employees, will, of course, be retained.

The income tax code gives generous tax relief in respect of premiums paid by individuals on life assurance policies. Up to 1953 the fraction of premium qualifying for relief was one-half. In the Budget of that year, with a view to ensuring the development of the Irish assurance industry, the qualifying fraction in the case of new policies with Irish companies was increased to two-thirds.

The Irish life assurance companies have improved their share of the market to the point where they now account for over 60% of premium income. Moreover, investment in the Irish economy by non-Irish companies, now exceeds 90% of their Irish liabilities.

The Government have accordingly decided that, in the case of all policies taken out after today, the fraction of life assurance premiums qualifying for tax relief will be a uniform one-half. The tax relief will continue to be available at a taxpayer's marginal rate of tax.

As I have mentioned, the tax treatment of life assurance is generous and life assurance can be expected to remain a specially attractive means of long-term savings and family protection.

Considerable dissatisfaction has been expressed by employees affected by certain benefits-in-kind legislation introduced in 1976. This legislation imposed on employees who had the private use of employers' cars an income tax charge of 15% of the cost of the car, subject to a minimum of £300.

I am satisfied that this position is unfair to many employees — in particular to those who have to use their cars extensively for business purposes. Accordingly, I have decided to repeal the relevant 1976 legislation, with effect from April 6th next, thereby restoring the previous basis on which the value of the benefit to the employee was computed by reference to the actual amount of private mileage as compared with total mileage. The cost of this relief will be £2 million in 1978.

Before leaving the subject of personal taxation I should like to mention that representations have been made to me about the operation of the PAYE Table A — that is the tax-deduction table which applies for the purposes of deducting PAYE tax from employees with taxable incomes of £1,500, or less, in a year. It can lead in certain circumstances to a situation where an employee's after-tax income towards the end of the year might be somewhat less than it was at the beginning of the year. In view of this, the Revenue Commissioners at my request, have prepared a new Table A which will have the effect of spreading the tax deduction evenly throughout the year.

As I said at the outset, this Budget is designed to create the conditions under which the private sector can move ahead and take over as a prime generator of economic growth and employment. One of the most important ways in which a Government can set this process in train is by so tailoring the taxes which business has to bear as to ensure that the spirit of enterprise and expansion is positively encouraged.

I now turn, therefore, to a package of tax changes designed to give the necessary encouragement to business.

### II. PROPOSALS AFFECTING BUSINESS

*A. Special incentives for companies*

Under a three-year scheme introduced las year, manufacturing companies generall can enjoy a special 25% rate of corporatio tax provided that they expand activity t meet certain minimum targets. For 197 these targets were an increase of 3% i employment and an increase of 5% in vol ume of sales over 1976 levels.

I propose that for the remaining two years 1978 and 1979, there will only be an em ployment target to be met Manufacture will therefore qualify for the special 25 corporation tax relief for each year if the increase their employment by 3% in eac year. Credit for extra employment create over the target rate can be carried forwar to the next year within the period of th scheme. In any case, all manufacturers wi have the option of qualifying in 1978 an 1979 by reference to a 3% increase in em ployment over the immediately preceding year, if that is to their benefit.

I trust that my simplification of the targets and my announcement now of the employment test for 1978 and 1979 will create a favourable climate in which manufacturers can plan ahead with confidence and so encourage early expansion of manufacturing activity and employment.

### *B. Depreciation*

As regards capital allowances allowed to industry for tax purposes, deputies will be aware that "free depreciation" for new plant and machinery enables the entire cost of such investment to be deducted straightaway for tax purposes. It is on a permanent basis in the designated areas. In the rest of the country, however, it has been subject to renewal at intervals of two years since its introduction in 1971.

The current two-year period is due to end in March 1979. The purpose of the short-term basis of free depreciation in the past was to stimulate early investment by manufacturing industry as well as to keep options open in the matter of the long-term level of capital allowances for new plant and machinery. The Government have decided that the need for industrial growth would be better served by allowing free depreciation for plant and machinery as a normal and continuing feature of our capital allowances arrangements for the whole country.

For industrial buildings, the initial capital allowance at present stands at the accelerated rate of 50% which is also on a temporary statutory basis. Having considered the matter, I propose that free depreciation will be available to industrialists for their expenditure on new industrial buidlings with effect from tomorrow. This means that as much as 100% of the capital cost can be written off in the first year, if so desired. The allowance will be on a net cost basis as at present — that is to say, net cost after deduction of grants payable.

The detailed provisions in relation to capital allowances will be included in the Finance Bill.

### *C. Stock relief*

Stock relief was introduced in 1975 as a means of counteracting, in an *ad hoc* manner, the effects of inflation on the liquidity of firms in the main sectors likely to be most seriously affected. Despite the significant drop in the inflation rate, I propose to continue the stock relief on the existing basis for a further year. This will cost £5 million in 1978. [1]

1. *Editor's note:* Stock (inventory) relief is a deduction to be allowed in computing taxable profits of the amount by which the increase in value of trading stocks at the end of the accounting period exceeds 20% of the trading profits. This relief is given to Irish resident companies engaged wholly or mainly in the manufacturing, construction or farming, or in the sale of machinery and plant (excluding passenger vehicles) or goods to concerns for use by them for traders of that nature.

**SUMMARY OF THE BUDGET STATEMENT ***

*Wealth Tax*
The tax is to be repealed with immediate effect — i.e. with effect from and inclusive of the next valuation date, 5 April 1978.

*Capital Gains Tax*
For chargeable gains after 5 April 1978:

- adjustments for inflation as measured by changes in the Consumer Price Index to be made in calculating all chargeable gains;
- for all assets except shares and development land, the present flat rate of 26% is to be replaced by a sliding scale starting with 30% and reducing in three-year spans to Nil after 21 years;
- for shares and development land, a flat rate of 30% is to apply.

*Personal Allowances*
With effect from 6 April 1978:

| | | | | | |
|---|---|---|---|---|---|
| Single Person | — Increased | by | £200 | to | £ 865 |
| Married Couple | — Increased | by | £630 | to | £1,730 |
| Widowed Person | — Increased | by | £200 | to | £ 935 |

Other Allowances — Unchanged, except that the deduction of two-thirds of qualifying premiums paid to Irish life assurance companies has been reduced to one-half to fall in line with premiums paid to non-Irish companies.

*Other Personal Income Tax Changes*
The maximum limit (£2,000) for deducting premiums paid by self-employed persons towards retirement annuity contracts has been removed so that the only limit will be 15% of relevant earnings.

Thalidomide Children — the interest from investment of their lump-sum compensation awards is to be exempt from income tax.

Taxable Benefits — the arbitrary minimum assessment based on 15% of company-provided cars is to be removed so that assessments will be based only on actual circumstances.

*Capital Allowances*
Free depreciation for plant and machinery due to expire at 31 March 1979 is to be made a permanent part of the tax system.

Free depreciation for expenditure on industrial buildings is introduced to take effect from 2 February 1978 (replaces existing 50% first year allowance).

*Stock Relief*
The relief for increased stock values in manufacturing, construction etc. businesses has been extended for a further year.

*Small Companies Relief*
The limit for the small companies corporation tax rate (35%) has been increased from £10,000 to £25,000 with retrospective effect from 1 January 1977 and the gradual progression to the full corporation tax rate (45%) now applies to profits between £25,000 and £35,000.

*Special Incentives for Manufacturing Industries*
For 1978 and 1979, manufacturing companies will qualify for the special 25% corporation tax rate if the employment provided increases by at least 3% over the immediately preceding year. (For 1977, both a 3% increase in employment and a 5% increase in sales volume was required).

*Farm Taxation (from 1978/79)*
Full-time farmers will now become liable to income tax when the rateable value of their lands exceeds £60 (previously £75) but local rates may now be credited against income tax on farm profits.

Notional basis farmers will be taxed on the basis of 90 (previously 65) times rateable value of lands (subject to deduction of certain expenses). The selection between the notional basis and accounts profit basis must now be made on a three year basis.

Agricultural and Fishery Co-operatives are to be exempted from corporation tax except in respect of income from sales to the European Communities Intervention Agency.

*Value Added Tax*
The limits of accountability for VAT of small traders is to be increased by approximately 50% over present levels.

Taxable customers of unregistered farmers to be allowed claim an input credit equal to 1% of cost of farm products purchased.

Cattle marts to be taxed as dealers in cattle but at new 1% rate, instead of 10% which would otherwise have applied, on their commissions.

* Prepared by our correspondent, Mr. Norman E. Judge, Dublin.

*D. Small companies*

I have been very conscious of the need to do everything possible to help small firms. It is most desirable that the possibilities for growth of small firms be fully exploited to the national advantage. A number of them already engage in exporting and I am anxious to see more of them becoming export-orientated. These firms at present account for a substantial part of employment in manufacturing industry and the possibilities for future job-creation will be clear.

I propose to raise the present corporation tax thresholds for small companies from £10,000 and £15,000 to £25,000 and £35,000, respectively. The revised thresholds will be for the purpose of applying the 35% to 45% range of rates and the 45% rate, respectively. In order to give a useful boost to the companies' cash position in 1978, by reducing their current tax payments in respect of 1977 profits, I propose to backdate the increase in thresholds to profits from January 1st, 1977. The cost to the Exchequer is £400,000 in 1978. I am confident that this will provide a welcome stimulus to small companies.

*E. Interest restrictions*

I also propose that after today unrestricted interest relief will be allowed to any individual in respect of borrowings made to enable him to acquire shares to any extent in a private trading company, whether he is engaged in the company as a full-time employee or in a part-time capacity. At present, unrestricted relief is allowed for such borrowings only if the individual spends most of his time with the firm and owns at least 5% of the shares. This will cost £70,000 in 1978.

*F. Small firms: investment finance*

If small firms are to expand quickly they must have access to the necessary investment finance. The European Investment Bank is an appropriate source of long-term development funds. It has lent over £145 million in this country, mainly for the public capital programme, since our accession to the European Communities. Strong representations have been made that small firms, in particular, are inhibited from availing themselves of the Bank's facilities by the risk inherent in borrowing foreign currencies.

Exchange rate changes can impose considerable additional costs which cannot be foreseen when a loan is taken out. I have decided, in principle, therefore, that the Exchequer should assume the exchange risk liability on borrowing by the Industrial Credit Company from the European Investment Bank for on-lending to small firms in the manufacturing sector. I have also arranged that the Industrial Credit Company's margin for administration expenses in relation to this scheme will be at a specially low rate. I hope the way will now be clear for an expansion of the Bank's lending operations in Ireland. I shall be making a more detailed announcement as soon as the necessary consultations with the Bank have been completed.

*G. Aid for labour intensive industries*

The Government are concerned at the difficulties being experienced at present by certain labour-intensive sectors of industry, owing to the increased competition arising from the existence of special measures adopted by the British Government to maintain employment. The sectors particularly affected are the clothing, footwear and some areas of the textiles industry on which the British measures have had a very serious impact.

The Government decision in principle, which has already been announced, to introduce pay-related social insurance contributions in 1979, should be of assistance to labour-intensive fims, large and small. So also will be the tax concessions which I have announced. The Government feel that more immediate aid may be required, however, and they have decided, therefore, that firms engaged in the particular sectors of industry which I have mentioned should be assisted by a payment of £5 per week in respect of each worker on their payroll. This measure is intended to be of a temporary nature. It will be reviewed when the fully pay-related social insurance contribution system comes into operation. In any event, it will end as soon as the British scheme is terminated. The scheme will come into operation from the beginning of April and details will be announced as soon as possible. I am allocating a sum of £5 million for this purpose in the current financial year.

In the context of assisting small business, I also intend to introduce shortly a scheme which will readjust the incidence of excise duty on beer so that the smaller producers will bear a somewhat lesser burden of duty while the larger producers will pay somewhat more. There will be a net cost to the Exchequer of about £300,000 this year.

The purpose of this scheme, which has the support of all the brewers, is to help offset certain disadvantages which smaller producers can encounter, particularly in the restricted home market. This should benefit employment in the industry as well as contributing to consumer choice.

*H. Duty-free facilities*

I have already announced, of course, the introduction of duty-free facilities on sea and air routes between this country and Britain, with effect from March 1st, 1978. This will be of particular assistance in the drive to expand tourism which was envisaged in the White Paper. This concession, which will cost about £5 million in 1978, should help tourist numbers to exceed two million in 1978 and to reach the target of 2.4 million in 1980. It will benefit the economy generally and our carriers in particular.

I have no other proposals with regard to excise duties! If I am not proposing any increases in excise duties today, I trust its significance will not be overlooked. It is intended as another substantial contribution by the Government to the process of reducing the rate of inflation to a level at which price increases are not disruptive either of private living standards or of the economy generally. It is a positive contribution because, for the most part, excise duties are flat-rate and not a percentage of the price of the product.

Thus, the longer the excise duties remain unchanged the more the relative weight of these taxes in the price of the goods concerned diminishes.

## III. WEALTH TAX: ABOLITION

Both in Opposition, and again on resumption of office, this Government undertook to review the system of capital taxation introduced by its predecessor. This review has now been completed and legislation will be introduced shortly proposing the following changes in the capital taxes.

When the wealth tax legislation came before this House in 1975 it was opposed by the present Government basically on the grounds that it was detrimental to the economic interests of the country at its present stage of development. I see no reason to change that view. There were indications of an outflow of badly-needed private funds in 1975 and 1976 and, while one cannot be definite about the reasons for the outflow, it seems to be more than coincidence that it occurred at the same time as wealth tax was introduced.

This, of course, is only one side of the coin. The other side is the amount of capital which would have flowed into the country were it not inhibited from doing so by the very aura of a wealth tax. The amount involved can only be conjectural, but, taking both sides of the coin together, one certain result emerged. Existing jobs were lost and jobs in prospect never came to fruition. The wealth tax has undoubtedly created a psychological climate in which investment and risk-taking have been at a decided discount.

Among other demoralising side-effects is the discrimination against Irish business. I have decided for these reasons to abolish wealth tax with effect from April 5th next.

The cost in the present year is estimated at £8.5 million. If my hopes about the effect on enterprise of the abolition of wealth tax are realised, the small size alone of this figure will give the lie to any critic who might suggest that this Budget favours the wealthy. It is insignificant in comparison with the hundreds of millions of £s of new job-directed expenditure allocations and the across-the-board tax concessions I am providing for today.

## IV. CAPITAL GAINS TAX: SLIDING SCALES

The present Government never opposed the principle of a tax on capital gains but they did consider that instead of a flat rate of tax there should be a sliding scale under which the speculator would pay more tax than a person who had spent the best part of a lifetime building up a business.

I propose with effect from April 6th next to introduce, in the case of the generality of assets, a new scale starting at 30% and reducing in 3-year spans to nil after 2 years. The period of 21 years will run from the date of acquisition of the asset, irrespective of when it was acquired. In the case of a limited number of assets, shares and development land, for instance, a flat rate of 30% will apply. In all cases adjustments will be made to allow for inflation as measured by the consumer price index. The changes will not result in any cost to the Exchequer in 1978 as capital gains tax is paid a year in arrears.

## V. CAPITAL ACQUISITIONS TAX (INHERITANCE TAX)

Again the Government has no quarrel in principle with the capital acquisitions tax. I do propose, however, to increase certain thresholds. In particular, I intend to double the threshold in Tables II, III and IV of the Second Schedule to the Act which, I believe, were fixed at too low a level in the first instance. These changes will, of course, involve readjustments to the various ranges within these Tables. The cost of all the adjustments is estimated at £1 million in 1978.

Last year An Taisce published a report which was a plea to the Government to come to the aid of our heritage houses, gardens and collections which are a significant national asset — economic and educational as well as artistic. In particular, the Council of An Taisce considered that the new capital taxes had serious implications for these houses and would endanger elements of the country's heritage already under serious pressure.

The Government are sympathetically disposed towards the preservation of heritage houses and do not think that the nation should lightly run the risk of losing valuable and irreplaceable cultural assets. It is true that the changes in capital taxation already announced by me will bring relief but this is less so in the case of capital acquisitions tax. I propose, therefore, to consider how best to draft legislation aimed at relieving these properties of capital acquisitions tax. Questions of definitions will have to be decided and I consider that relief should be contingent on public access being allowed to the properties. It is difficult to estimate what the cost of this concession is likely to be but I am allowing £200,000 in respect of the present year.

## VI. FARMERS' TAXATION

After decades of depressed and unstable price levels and insecure markets, the farming sector has, thanks mainly to our membership of the E.E.C., enjoyed considerable advances in income in recent years. In the coming years, farmers can continue to plan against the background of security of markets for their output. We have, now, a solid basis for greatly expanding the contribution of this sector to our economic wellbeing. This is an opportunity that must not be missed, and the community looks to the farmer to exploit it to the full.

Everyone accepts that farmers should make their due contribution in taxation. It is the policy of the Government that this contribution should be equitable having regard to progress in the level of farmer incomes while, at the same time, bearing in mind the special nature of the agricultural industry and its development needs.

It was against this background that the Government undertook in the manifesto to make certain changes in the system of taxing farming profits. The Government intend to honour these undertakings and provision to give effect to them will be made in the forthcoming Finance Bill. I will briefly list these changes.

The notional basis of assessment will be retained as an alternative to assessment on the basis of accounts. Farmers will, however, be required to remain for three years with whatever option they choose, because switching from one basis to the other could provide scope for unfairly minimising tax liability.

Fulltime farmers will be allowed a single payment date in the income tax year, namely, 1st January. Consequently, the White Paper, or pre-Budget, estimate of revenue from fulltime farmers in 1978 falls to be reduced by £5 million, that is the amount which they would have paid in September next under the former two-payment system.

Contractors' fees will be allowed as a deduction before assessment of income on a notional basis.

Allowances will continue to be given for wages of employees who are registered for PAYE and social welfare purposes.

Fulltime farmers will be allowed the amount of their preceding year's rates on land as a credit against their tax bill.

There will be a system of income-averaging for farmers. Discussions are being held with the farming organisations with a view to arriving at an appropriate system. Discussions are also taking place on the system of valuing breeding livestock for tax purposes.

As I have already said, it is our policy that taxation of farmers takes due account of progress in farmers' incomes. These incomes have more than doubled in the four years since the introduction of farmers' income taxation in 1974. In the income tax year 1977/78, the yield from taxation of farming profits is expected to be about £14 million.

This return must be regarded as low in the light of the increases which have taken place in farm incomes. The Government have, therefore, decided to increase from 65 to 90 the multiplier which is used to calculate a farmer's notional income.

The Government have also decided that the threshold for liability to income tax should be lowered from £75 rateable valuation to £60 rateable valuation. This will bring a further 7,000 full-time farmers into the tax net, making about 22,500 farmers in all liable for income tax.

The effect of the foregoing measures is that farmers will pay about £24 million in tax in the income tax year 1978/79.

An announcement has already been made by the Minister for the Environment to the effect that farmers with reateable valuations of £75 or over will no longer be eligible for rates relief by way of the Agricultural Grant, resulting in a saving to the Exchequer of about £7 million in 1978. The Government have decided that the rateable valuation ceiling for determining eligibility for such rates relief will in future be the same as the valuation threshold for income tax liability. The effect of this decision will be that, in 1979, farmers whose rateable valuations are £60 or over will not benefit from the Agricultural Grant, but they will be able to set their 1978 rates against their tax bill.

### *A. Cooperatives*

This Government have always recognised the importance of the activities of co-operatives in the development of Irish agriculture and fisheries. We gave a commitment to restore an exemption from corporation tax in respect of such activities. A provision will accordingly be included in this year's Finance Bill to exempt certain profits made by these co-operatives as from April 1st next.

Apart from some modifications, the exemption will be similar to that enjoyed by agricultural and fishery co-operatives up to April 6th, 1976. The Government are satisfied, however, that the best interests of Irish agriculture and fisheries would not be served by allowing sales to the Intervention Agency to benefit from the exemption.

### *B. VAT*

As Deputies are aware, the Value-Added Tax (Amendment) Bill 1977 passed its Second stage in November. That Bill arose out of an E.E.C. Directive of 1977. The date for the coming into operation of the Bill, when enacted with any necessary amendments, depends on a number of factors. Representations have been received on different points and I am considering them.

Moreover, decisions may be taken in Brussels postponing the date for implementation of the Directive by those Member States — the great majority — which have not yet enacted the necessary legislation. I cannot, therefore, at this stage be specific about the likely timetable for the Bill or say when the new arrangements will come into operation. Adequate notice will be given.

I should mention that I propose to add provisions to this Bill for a considerable increase in the turnover thresholds for compulsory VAT registration of traders. I have been impressed by representations made to me that the existing thresholds, which have been unchanged since VAT was introduced in 1972, are too low. The increases I have in mind raise the present thresholds, generally, by about 50%. The cost to the Exchequer of this change, which will come into operation in due course, will be £250,000 in a full year.

I am sure this will be welcomed by many small businesses. Additionally, the Revenue Commissioners are actively pursuing at my request the question of simplification of VAT returns and records, with particular concern for the smaller businesses.

There are two VAT matters affecting farmers for which I will also be proposing to add provisions to the Bill. These are the flat-rate credit and the treatment of cattle marts.

The 1% VAT recoupment allowed to VAT-registered customers of unregistered farmers was abolished in 1976. This deprived farmers of compensation for VAT borne by them on machinery and other inputs. We have already announced our intention to restore recoupment and I propose that this be effected within the 1978/79 income-tax year.

The exact date will be linked with an arrangement which I have in mind in relation to the bringing of cattle marts into the VAT system under E.E.C. requirements. This will involve treating the marts as dealers in cattle for VAT purposes. The result will be that their commission will effectively bear VAT at 1% — instead of the 10% which would be the case if the VAT system were applied to them in the ordinary way.

# Cumulative Index 1978 - Nos. 1 & 2

ASIA:

# The Taxation of the Asian Dollar Market

by M. P. Dominic*

## INTRODUCTION

The Asian Dollar Market is very similar to the Euro Dollar Market and the interest rates in the Asian Dollar Market follow the interest rates in the Euro Dollar Market very closely. The majority of the transactions are in U.S. dollars, the balance in the Asian Currency Units. In Singapore, the Asian Currency Units are specified by the Singapore Government. In general, they include all major convertible currencies. The market, which started in a small way, is developing into a well developed market in its own right. The Asian dollar deposit rate has grown from $ 30.5 million in 1968 to about $ 1.6 billion in 1977. The major depositors are the governments of the region, Asian central banks, multinational corporations, international banks, regional companies and wealthy individuals. The market generally caters to the needs of the Asia-Pacific Region. The major borrowers are the governments of the region, the banks operating in the region, multinationals, export oriented regional companies, etc. About three quarters of the loans are made to the governments of the region. The Asian dollar bond market is still in its infancy. Its potential is shown by the two successful issues totalling $ 50 million by the European Investment Bank.

The main centres of the Asian Dollar Market are *Singapore* and *Hong Kong*. The Singapore Government actively encourages the development of the market in Singapore by providing fiscal and non-fiscal incentives and concessions. It has liberalized the exchange control provisions to facilitate international financial transactions, has a liberal though selective policy on the entry of foreign financial institutions, provides for development of training facilities, adopts a liberal policy on the entry requirements of skilled personnel and has granted a number of fiscal incentives to promote the growth of banking activities and the development of the Market. On the other hand, Hong Kong does not provide any fiscal incentives to attract the market. However, it has, with its freedom from exchange controls, well developed financial expertise. Its policy of taxing only Hong Kong source income has made it one of the major centres for the Market. In addition, the Philippines and Sri Lanka are making attempts to enter the field.

For the development in a country of an international or regional capital market such as the Asian Dollar Market, a number of tax considerations must be kept in mind. They are:—

(i) the withholding tax on interest payable on debt obligations to foreign holders;
(ii) incidence of estate duty in the borrower's country in the event of the death of the foreign holder;
(iii) stamp or other duties on the issue of bonds, debentures, etc.;
(iv) taxation of income of the financial institutions from the Asian Dollar Market activities.

### A. Withholding tax on interest payable on debt obligations to foreign holders

Depositors of funds in the market, whether they are institutional investors such as pension funds, international banks, international companies or wealthy individuals would prefer to receive the maximum interest on their deposits. A withholding tax on interest will reduce the stated interest and, hence, the deposit funds would be attracted to a country with the least incidence of tax on the interest. Similarly, in the case of debentures issued in the market, the debentures usually include an indemnity clause against any reduction in the stated interest on account of any income tax in the source country. [1] This market preference for the payment of the stated interest without deduction of withholding income tax is due to:

(i) the non-availability of foreign tax credit in certain countries for the withholding tax imposed in the source country;
(ii) exemption of foreign interest income in certain countries;
(iii) the imposition of withholding income tax, in a

* Attorney at law, Sri Lanka, Drs. in de rechtswetenschappen (Netherlands). Formerly visiting lecturer at the University of Sri Lanka (Colombo) and tutor at Sri Lanka Law College.

1. The debentures usually also include a clause for the exemption of indemnity in the event of withholding tax deduction arising from any business or other connection other than as a lender to the source country. They also provide for redemption by the issuer at a premium if there is a change in the law of the source country with regard to the withholding income tax on interest.

number of countries, on gross interest and the consequent high effective tax rate; and

(iv) in certain (many!) cases the interest income is not declared by the lender in his return to the tax authorities of the lender's country.

In view of this market preference, both the financial institution which accepts the deposits and the issuers of debentures and other debt obligations should try to structure their activities in a country without withholding income tax on interest. Even tax treaties may not be of much benefit, especially in the case of public issues, because the underwriters may wish to be free to sell the debentures also to residents of non-tax treaty exemption countries. Similarly, the holders of the debentures may prefer to resell their debentures in the secondary market to residents from non-tax treaty exemption countries.

### 1. *Singapore*

For this reason in Singapore by an amendment introduced in 1969, exemption is granted for income derived on or after 20 August 1968 from interest on moneys held in deposit in an approved bank in Singapore by:—

(i) a non-resident individual; and
(ii) a person other than an individual, if such person does not, by himself or in association with others, carry on business in Singapore, and does not have a permanent establishment [2] in Singapore.

Further, an exemption from income tax is also granted by an amendment introduced in 1973, for interest received from such Asian Dollar Bonds issued in Singapore as may be approved in writing by the Minister if the interest is received by:

(i) a non-resident individual; and
(ii) a person, other than an individual if that person does not, by himself or in association with others, carry on a business in Singapore and does not have a permanent establishment in Singapore.

Hence when the exemption was introduced in 1973, the exemption was available only in Asian Dollar Bonds issued in Singapore. However, after an amendment introduced in 1977, the exemption is not confined to Asian Dollar Bonds issued in Singapore. It may be noted that in order to be eligible for exemption the Asian Dollar Bonds must be approved by the Minister. Interest received from an Asian Dollar Bond not approved by the Minister is subject to a withholding tax of 40 percent.

The two exemptions will not cover inter-bank financing if the lender has a branch in Singapore.

### 2. *Hong Kong*

In Hong Kong, an interest tax at the rate of 15 percent is imposed on the gross interest arising in or derived from the Colony (Hong Kong) on any debenture, mortgage, bill of sale, deposit loan, advance or other indebtedness whether evidenced in writing or not. Hence, the 15 percent tax is imposed on Hong Kong source interest and the exemptions granted are not very relevant for the Asian Dollar Deposits and Bonds. The tax must be deducted at source.

Though it had been suggested to the Government of Hong Kong that the interest tax should be abolished, it has not done so until now. The abolition of the tax could lead to Hong Kong residents making "back to back loan arrangements" with banks in New Hebrides, Cayman Islands or other tax havens and then claim deduction for interest paid on such loans and enjoy interest income tax free. This would lead to erosion in tax base and strict anti-avoidance measures would be needed. [3]

The development of the Asian Dollar Market would have been inhibited by the imposition of the interest tax, if not for the territorial principle of taxation followed in Hong Kong. Interest tax is imposed only on Hong Kong source interest, and hence the interest tax could be avoided if it is established that the interest does not arise in Hong Kong. Thus, where deposits are received by banks in Hong Kong as intermediaries, the interest on such deposits will not be subject to interest tax in Hong Kong.

If Hong Kong Bank X received deposits in Dutch guilders as an intermediary and Bank X arranges for a deposit to be made in the customer's name with its branch or correspondent Bank Y in a country outside Hong Kong (e.g. Singapore), the interest payable by Bank Y will not be subject to interest tax in Hong Kong. In such a case, the depositor's account will not appear as a liability in Hong Kong Bank X.

Similarly, where a borrower applies to Bank X in Hong Kong for an Asian Dollar Loan and Bank X sends the application to its branch or correspondent Bank Y in Singapore, the interest payable on such loan granted

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2. A "permanent establishment" is defined as a fixed place where a business is wholly or partly carried on including:—
(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a warehouse;
(f) a workshop;
(g) a farm or plantation;
(h) a mine, oil well, quarry or other place of extraction of natural resources;
(i) a building or work site or a construction, installation or assembly project, and

without prejudice to the generality of the foregoing, a person shall be deemed to have a permanent establishment in Singapore if that person
(j) carries on supervisory activities in connection with a building or work site or a construction, installation or assembly project; or
(k) has another person acting on that person's behalf in Singapore who—
   (i) has and habitually exercises an authority to conclude contracts;
   (ii) maintains a stock of goods or merchandise for the purpose of delivery on behalf of that person; or
   (iii) habitually secures orders wholly or almost wholly for that person or for such other enterprises as are controlled by that person.

3. John F. Chown and Dr. Thomas F. Kelan, Offshore Investment Centres (Bimher Research Unit, London) p. 33.

by Bank Y will not be subject to interest tax in Hong Kong since the interest has no Hong Kong source. The loan is processed by Bank Y and it decides to grant (even though on the basis of the recommendation of Bank X) the loan. The loan is not by Bank X and hence the customer will not be shown as a debtor in the books of Bank X. In this manner the Asian Dollar business may be first negotiated in Hong Kong and then put through the books of the Hong Kong Bank's branch or correspondent bank in Singapore. Only a "Memorandum Account" will be maintained in Hong Kong. In this manner, the operations in Hong Kong and Singapore are in fact complementary. No interest tax will be imposed in Hong Kong on interest arising from such a transaction. In some cases, the Hong Kong bank uses its branch or correspondent bank in London, New Hebrides or Cayman Islands. However, the Inland Revenue Department has warned that if there are associated transactions to the above-mentioned transactions in Hong Kong in Hong Kong dollars, it is likely to take the view that the credit is effectively being made available in Hong Kong.

*3. Philippines*

In the Philippines, all income of non-residents from transactions with either an offshore banking unit or with an expanded Foreign Currency Deposit Unit are exempt from tax. [4]

## B. Incidence of Estate Duty in the borrower's country in the event of the death of the foreign lender

When a foreign lender is an individual and he dies, the situs of the debt is in the country in which it is lent and hence could be subjected to estate duty in that country. This may be an impediment to attracting deposits and lending activities to a particular country. For this reason, in Singapore, an exemption from estate duty is granted in respect of deposits and balances with Asian Currency Units of approved banks, Asian Dollar Bonds and Government Bonds, stocks and securities in the event of the death of a non-resident person not domiciled in Singapore. [5]

## C. Stamp duty or other duties on the issue of bonds, debentures etc.

The stamp duty burden on multi million loans could be fairly high and this could further hinder the development of Asian Dollar Market in the country. The cost of obtaining a loan will become high and issuers of debentures and bonds may prefer a country with no stamp duty or lower rate of stamp duty. In Singapore, the Finance Ministry has agreed to reduce to a nominal sum the ad valorem stamp duty on Asian Dollar Loans. The present duty is fixed at ½ percent on the offshore loans under the Stamp Duty Act. Banks can apply individually to the Finance Ministry for permission to waive this duty rate. [6]

## D. Taxation of income of the financial institutions from the Asian Dollar Market activities

In general the Asian Dollar Market operations, especially inter-bank transactions, are carried on by the financial institutions on small margins. A high rate of income tax will hinder the development of such a market in the country.

*1. Singapore*

In Singapore, under Sec. 43A of the Income Tax Act (introduced by an amendment in 1973), a reduced rate could be imposed on the offshore income of a financial institution derived by it from the operation of its Asian Current Unit approved by the Minister. "Offshore income" means income derived from loans made to persons outside Singapore to be used outside Singapore where the interest on such loans is not borne directly or indirectly by a person resident in Singapore or a permanent establishment in Singapore. The reduced rate is fixed at 10 percent. The reduced rate is imposed on the offshore income even if the income is not remitted to Singapore. [7] Other income arising from Asian Dollar Market Operations would be subject to the 40 percent rate. However, such income is subject to the 40 percent rate only if remitted to Singapore. Otherwise they would be exempt. When the reduced rate was introduced in 1973, it was applicable only to interest on loans used outside Singapore and not borne directly or indirectly by a person resident in Singapore or a permanent establishment in Singapore. It was not applicable to inter-bank operations. Loans made by financial institutions outside Singapore for the latter's own use will not qualify for this exemption. This provision has been applied with flexibility and transactions where the ultimate recipient is an offshore borrower are considered favourably. [8] This position was changed by an amendment made in 1977. Under this amendment, the reduced rate will apply to much wider transactions including inter-bank transactions (other than transactions with banks in Singapore). [9]

Under the amendment, "Offshore income" means:

(a) income derived from loans made to persons outside Singapore to be used outside Singapore where the interest on such loans is not borne, di-

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4. Regulations Governing Taxation of Offshore Banks and Foreign Currency Units of Depository Banks Established under P.D. 1034 and 1035 respectively. An (expanded) Foreign Currency Deposit Unit is defined as an accounting unit or department in a local bank or in an existing local branch of foreign banks, which is authorized by the Central Bank of the Philippines to operate under the expanded foreign currency system.
5. Tax News Service, 1976 II 56.
6. Tax News Service, 1977 II 4.
7. It may be noted that in Singapore, foreign income of a resident person is taxed only on remittance basis. A non-resident is exempt from tax on foreign income even if the foreign income is remitted to Singapore. See: M.P. Dominic, Singapore: Foreign Investment and Tax Treaties, Bulletin for International Fiscal Documentation 1977 (Vol. 31), p. 268.
8. J.F. Chown and Dr. Thomas F. Kelan, p. 33.
9. Tax News Service, II 4.

rectly or indirectly, by a person resident in Singapore or a permanent establishment in Singapore; and

(b) fees, commission or interest received from advising or confirming offshore letters of credit from transactions in bills drawn on such letters or credit.

The term "Offshore letter" is defined as a letter of credit subject to the following conditions:—

(a) the letter-of credit is opened in currencies other than Singapore dollars;
(b) neither the buer nor the seller who is a party to the letter of credit is a resident of Singapore or a permanent establishment in Singapore; and
(c) the goods covered in the letter of credit are not exported from or imported into Singapore.

The reduced rate will not apply to exchange gains and transactions with either domestic banking institutions or Singapore residents. Such gains and transactions will be subject to the normal 40 percent income tax. [10]

However, it may be noted that the advantage for a resident financial institution of the reduced rate of 10 percent may be annulled in view of Section 44 of the Income Tax Act. Under Sec. 44 of the Income Tax Act, every resident company is entitled to deduct income tax from the amount of any dividend paid to any shareholder at the rate of 40 percent. Where the tax payable by the company on its income exceeds the tax deducted by it from dividends, the excess may be carried forward to the next year and will be added to the tax payable on income in that year. The tax deducted in that year will be set off in that year against the aggregate of the tax payable on income in that year and the excess carried forward from the previous year. On the other hand, if the tax deducted from dividends in one year exceeds the tax payable on income in that year, the excess must be paid to the Revenue. It may not be carried forward to the following year. This may result in a 40 percent effective rate when dividends are paid even if the income from which the dividends are paid is subject to the reduced rate of 10 percent. For example, if the offshore income is S$ 1,000 the tax payable at the reduced rate of 10 percent is S$ 100. However, if the financial institution is a resident company and pays dividends to its shareholders, the tax deducted is S$ 400. The excess of S$ 400 (the tax deducted from dividends) over S$100 (the tax payable on income in that year) must be paid to the Revenue and hence the effective tax burden is 40 percent. The financial institution will not benefit from the reduced rate of 10 percent. It may be noted that only a resident company need deduct this tax and a company may change its residence by changing its place of control and management. [11]

### 2. *Hong Kong*

In Hong Kong, the tax rate applicable to the profits of a financial institution is 15 percent. This tax is imposed only on Hong Kong source income. If the actual business is transacted outside Hong Kong, the profits will be exempt from Hong Kong tax. However, this exclusion may be affected by the recommendation of the Johnstone Committee [12] to tax the intermediate category of profits [13] which are not substantially caused by the action of a permanent establishment outside Hong Kong. Thus, if all the Asia Dollar operations are done through a Hong Kong Bank and the activity outside Hong Kong cannot be treated as an activity substantially caused by a permanent establishment outside Hong Kong, income from the whole operation will be taxed in Hong Kong. Further, the Committee has also recommended that the principle of levying tax on the "intermediate" category of profits should be extended to banking institutions and other deposit taking companies which accept deposits from Hong Kong public and in turn redeposit the proceeds in overseas markets (Asian Dollar Market) to profits from the interest differentials. "The reason for this extension is that the financial institutions in question make use of the Hong Kong infrastructure to acquire local deposits, the interest payments on which are tax-deductible, while interest receipts on Euro-dollar deposits are not due to the substantial intervention of any permanent establishment elsewhere and yet are not brought within the tax net". [14] This extension will not affect individuals and non-financial concerns depositing their funds in the Asia Dollar Market or other overseas market.

### 3. *Philippines*

In the Philippines, the Revenue Regulations No. 10-76 [15] have provided for a 5 percent tax on offshore income of the Offshore Banks and of the expanded Foreign Currency Deposit Units of Depositing Banks. The rate is 10 percent on the onshore income of such banks and deposit units. "Offshore income" is all income arising from transactions allowed by the Central Bank of the Philippines conducted by and between:

(a) in the case of an offshore banking unit with another offshore banking unit or with an expanded Foreign Currency Deposit Unit or with a non-resident;
(b) in the case of an expanded Foreign Currency Deposit Unit with another expanded Foreign Currency Deposit Unit or with an offshore Banking unit or with a non-resident.

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10. Tax News Service, II 4.
11. M.P. Dominic, Singapore: Foreign Investment and Tax Treaties.
12. Report of the Third Inland Revenue Committee, Hong Kong, 1977. See also, Y.C. Jao, Tax Reform and Fiscal Policy in Hong Kong, Bulletin for International Fiscal Documentation, Vol. 31 No. 4 (1977) pp. 175-184.
13. "The Category of profit in question would be defined by specifying that it was profit accruing in the course of the carrying on of a trade or business actively exercised in Hong Kong which was not substantially caused by the action (on behalf of the trade or business) of a branch organization located outside Hong Kong. The word "substantially" has been included to take care of the case where there is a branch which does something trivial like handling out a catalogue to an engineer whereas a director comes over specifically from Hong Kong headquarters to negotiate and conclude the actual contracts". Report of the Third Inland Revenue Committee, para. 126.
14. Y.C. Jao, Tax Reform and Fiscal Policy in Hong Kong, p. 180.
15. See note 4, supra.

The 5 percent rate is also imposed on income realized by offshore banking units on transactions with local commercial banks including branches of foreign banks that may be authorized by the Central Bank of the Philippines to transact business with offshore banking units. However, it will not apply on income from such transactions as may be specified by the Ministry of Finance, upon recommendation of the Monetary Board.

Hence, the 5 percent rate covers inter-bank transactions and transactions with outside customers.

"Onshore income" means interest income arising from foreign currency loans and advances to and/or investments with residents made by the Offshore Banking Units or expanded Foreign Currency Deposit Units. Such interest income includes all fees, commissions and other charges which are integral parts of the income from the above transactions.

The 5 percent tax is on the net "offshore income". The following deductions may be made from gross offshore income to determine the net offshore income.

(a) the proportion of total interest expenses based on the ratio borne by offshore interest income to the total gross income;
(b) the proportion of general administrative expenses based on the ratio borne by net offshore income to the total net income after deducting only interest expenses referred under (a);
(c) a reasonable amount of head office expenses in accordance with the ratio specified under (b).
(d) licence fees paid by offshore banking units.

The 10 percent rate is imposed on the gross "onshore income". No deduction is allowed.

The reduced rates of income tax apply, unlike Singapore, to practically all income from Asia Dollar Market transactions. It covers exchange gains and transactions with domestic banks and Philippine residents. However, it is doubtful whther there will be any significant difference between Singapore and the Philippines on taxation of income from transactions with residents (other than authorized Commercial banks in the Philippines) in view of taxation on a gross basis in the Philippines and taxation on a net basis in Singapore.

I have discussed only some of the fiscal considerations relating to the Asian Dollar Market. The other consideration will include taxation of income of expatriate skilled personnel.[16] They are not discussed in this paper.

Finally, it may be noted that Sri Lanka is also taking steps to attract the Asian Dollar Market. The Statement from the Prime Minister's Office dated 31 October 1977 has indicated that the Government plans to encourage the development of offshore banking activity. It states that "tax treatment will have to be liberal to compete with Singapore and other centres and it also connotes safety of deposits, quick and very efficient international banking services and the provision of first class export related services by the banking system."[17] Under the recently enacted "Greater Colombo Economic Commission Law", foreign banks will be allowed to be established in Sri Lanka. They may also operate secret numbered accounts.[18] The Government is at present formulating a fiscal incentive package and it is expected to be liberal.

16. In the Philippines, only a 15 percent rate will apply to salaries, wages, annuities, compensations, remunerations and emoluments received by alien individuals employed by Offshore banking units in the Philippines.
17. Ceylon Daily News, 31 October 1977.
18. See: The Greater Colombo Economic Commission Law.

**SINGAPORE:**

# 1978 Budget and Tax Changes

by Lee Fook Hong, FCIS, FAIA

On February 27, 1978 Mr. Hon Sui Sen, the Minister for Finance presented his 1978 Budget to the Parliament of the Republic of Singapore. His Budget Statement has been generally well received. The Budget was a pleasant surprise to many because it affects everyone favourably and especially the businessmen. The proposals in the Minister's Budget Statement are to stimulate the growth of export-oriented industries, strengthen the Asian Dollar market base and reflect a gradual shift in fiscal policy from taxation on income to taxation on consumption. The Budget is expected to consolidate the prevailing investment climate and boast Singapore as a warehousing and servicing centre.

In his Budget Statement the Minister announced an impressive list of incentives and concessions to stimulate the corporate sector and also immediate reductions in the rate of personal income tax varying from 7.8 percent to 18 percent. The objective of these reductions is to reward effort and excellence in performance and a more even distribution of the tax burden. These reductions are effective from the Year of Assessment 1978. They will cost the Government a revenue loss estimated at $53.9 million in the first year, out of a total tax collected on personal income of $370 million.

The tax changes announced include a new investment tax credit scheme allowing a certain percentage of the fixed investment of approved projects to be credited against taxable profits; a concessional 20 percent tax rate for overseas oriented sales and service companies; double deduction from income of operational expenditure for two years of permanent trading offices set up overseas; accelerated depreciation allowances for industrial buildings and abolition of tax charge on dividend distributions out of offshore profits. All these concessions are effective from Year of Assessment 1979.

While giving some concessions with one hand, the Minister takes away with the other by withdrawing some past benefits and raising some licence fees.

Colour television licence fees are increased from $36 to $54 per annum. Black and white sets are unaffected. Driving licence fees are increased from $10 to $20 per annum. Government tax on telephone bills is revised from April 1, 1978 from 15 percent to 20 percent.

Additional Registration Fees (ARF) on private cars are increased from 100 percent to 125 percent ad valorem. The preferential Additional Registration Fees (PARF) are correspondingly increased to 125 percent.

The Minister calls on the people of Singapore to work smarter and harder so that Singapore can repeat its 1977 performance of improved growth. He urges the people to put on an extra gallop in the year of the Horse to challenge, perhaps even beat, the growth rate in 1977.

Below are some extracts from the Minister's Budget Statement:—

### Singapore's Economy in 1977

1977 was a difficult year. World economic recovery slowed down.

The Singapore economy grew by 7.8 percent. Growth was led primarily by commerce and transportation. Most of the 33,500 new jobs were found in commerce and manufacturing sectors. As a result unemployment fell to 3.9 percent.

Growth was accounted for largely by the electronics and petroleum industries.

### Prospects for 1978

World trade has been forecast to expand at an even slower rate than the 6 percent of 1977. If unemployment continues to rise in the developed countries, the tendency towards protectionism will increase. This would make it more difficult for us to export. We must therefore be prepared to meet the challenge of what may turn out to be a difficult year. It would be optimistic for Singapore to expect real growth at more than 7.8 percent in 1977 if the OECD countries achieve a real growth of only 4 percent as they expect.

### Tax Changes

Over the last two decades Singapore has followed the path of financial prudence and probity. Annual budgets have been fairly predictable exercises in moderation and restraint. No radical tax changes have been enacted.

However, financial orthodoxy must be kept relevant to a changing situation by alterations in our tax structure to encourage economic expansion and diversification, to make Singapore an attractive centre for investment in manufacturing and servicing industries as well as a financial haven for capital. Consonant with these objectives, we have also encouraged the growth of savings and discouraged certain forms of consumption expenditure.

These basic policies will be continued and accelerated this year.

## TABLE A: TAX CHANGES AT A GLANCE

### NEW TAX INCENTIVES AND CONCESSIONS

**PERSONAL INCOME TAX (EFFECTIVE Y/A 1978)**

1. Reduced tax rates for most income brackets.
2. New tax rate of 45 percent for a chargeable income between $100,001 and $200,000.
3. 40 percent marginal tax rate for a minimum chargeable income of $50,001 against $35,001 previously.
4. 50 percent marginal tax rate for a minimum chargeable of $200,001 against $50,001 previously.
5. 55 percent marginal tax rate for a minimum chargeable income of $400,001 against $100,001 previously.
6. Maximum marginal rate of 40 percent for profits repatriated to Singapore.

**COMPANY TAX (EFFECTIVE Y/A 1979)**

1. *Investment Tax Credit Scheme*
Investment tax credit scheme which permits a percentage of the fixed investment of approved projects to be credited against taxable profit.

2. *Overseas-Oriented Sales & Service Companies*
Concessional 20 percent tax rate for overseas-oriented sales and service companies.

3. *Permanent Overseas Trading Offices*
Double deduction from income for two years of operational expenditure for permanent trading offices set up abroad.

4. *Depreciation of Industrial Buildings*
Accelerated depreciation from 45 years to 25 years for industrial buildings.
Initial depreciation allowance for industrial buildings increased from 10 percent to 25 percent.

5. *Offshore Profits*
Abolition of tax charge on dividend distributions out of offshore profits of financial institutions.

6. *Offshore Reinsurance Profits*
Abolition of tax charge on dividend distributions out of offshore reinsurance profits of insurance companies.

### TAX INCREASES

**PRIVATE MOTORCARS**

Additional registration fee for private motorcars increased from 100 percent to 125 percent ad valorem.

Preferential additional Registration Fee increased to 125 percent of its present rate for each class of vehicle, effective immediately.

**ENTERTAINMENTS DUTY**

Up 5 cents to 25 cents for every increase of 50 cents for admission charges exceeding $1.50 for cinema and amusement parks.

Up 5 cents for tickets priced at $1.00 or more for live entertainment such as stage plays and concerts.

Up 20 percent for establishments which pay lump sum entertainments duty and provide floor shows, music and dance facilities. All effective from April 1.

**DRIVING LICENCES**

Driving licence fee increased from $10 to $20 a year and provisional driving licence fee from $10 to $20 for six months, from April 1.

Telephone tax raised from 15 percent to 20 percent from April 1.

**COLOUR TV**

Colour TV licence fee raised to $54 from $36 a year for households and to $27 from $18 a year for hotels.

**FLIGHT TAXES**

Airport tax for flights to Malaysia and Brunei increased from $2 per passenger to $4 per passenger from April 1.

## Company Tax

In the earlier part of my Budget Statement, I indicated a number of tax incentives which will be given this year to stimulate the corporate sector. It may be convenient if I list them here also with other tax concessions I am giving:—

1. An investment tax credit scheme which permits a certain percentage of the fixed investment of approved projects to be credited against taxable profits.

2. A concessional 20 percent tax rate for overseas-oriented sales and service companies. Approved warehousing and related activities together with offshore trading, consultancy and other services which deal predominantly with offshore business in new spheres of activity will be granted a lower tax rate of 20 percent for a period of 5 years.

3. Double deduction from income of operational expenditure for 2 years of permanent trading offices set up abroad.

4. Accelerated depreciation allowances for industrial buildings. At present, industrial buildings have to be depreciated over 45 years for tax purposes. To lessen the tax burden, the Income Tax Act will be amended to allow industrial buildings to be depreciated over 25 years. The initial allowances will increase from 10 percent to 25 percent.

5. Abolition of tax charge on dividend distributions out of offshore profits. At present, financial institutions operating Asian Currency Units enjoy the concessional tax rate of 10 percent on offshore profits. However, this tax rate does not extend to dividend distributions made by such an institution out of offshore profits, so that it immediately incurs a further 30 percent tax charge on its dividend distributions. To further promote the development of the Asian Dollar Market, I have decided that the ACU tax concession will "follow through" for dividends received in the hands of both resident and non-resident shareholders. This means that the 10 percent tax on ACU offshore profits will be the final tax.

6. The "follow through" concessions will similarly apply to dividends paid out of offshore reinsurance profits of insurance companies.

   All these concessions will take effect from Year of Assessment 1979.

### Personal Income Tax

There is some evidence that high marginal rates of income tax in the middle income levels are becoming irksome and will in time become a disincentive to effort in Singapore. Fuelling this tendency is the effect of inflation, relatively mild as it is in Singapore, which has pushed income earners, at all levels, into higher brackets of taxation.

I have therefore decided, from Year of Assessment 1978, to make income tax less inequitable by broadening the steps over which the tax rate goes up.

(For details of the existing tax rates and new tax rates please see Table B.)

**TABLE B**
**PRESENT AND REVISED INCOME TAX RATES ON INDIVIDUALS**

| *Chargeable Income* $ | *Present Tax Rate* % | *Revised Tax Rate* % |
|---|---|---|
| 0 — 2,500 | 6 | 5 |
| 2,501 — 5,000 | 9 | 8 |
| 5,001 — 7,500 | 12 | 10 |
| 7,501 — 10,000 | 15 | 12 |
| 10,001 — 15,000 | 20 | 15 |
| 15,001 — 20,000 | 23 | 20 |
| 20,001 — 25,000 | 25 | 25 |
| 25,001 — 35,000 | 30 | 30 |
| 35,001 — 50,000 | 40 | 35 |
| 50,001 — 100,000 | 50 | 40 |
| 100,001 — 200,000 | 55 | 45 |
| 200,001 — 400,000 | 55 | 50 |
| 400,001 and above | 55 | 55 |

### Tax on Repatriated Profits

Under Singapore tax laws, profits and dividends, remitted into Singapore and received by an individual are taxed at the marginal rate. In many cases, the burden of Singapore tax on such income is very substantially reduced by double taxation relief provided under tax treaties Singapore has concluded with a number of countries. However, for countries with which Singapore has no double tax treaties, the marginal tax burden on the individual can go up to 55 percent.

In order to provide some incentive for the repatriation of overseas income, I have decided that such income shall be subject to a maximum rate of 40 percent with effect from Year of Assessment 1978.

### Garden Tax

As part of the campaign to make Singapore a clean and green city, a tax incentive was given to owners and occupiers of houses to encourage them to maintain clean and attractive gardens which can be seen by passers-by. A remission of tax up to $100 incurred in the maintenance of private gardens was granted in 1970. This amount was increased to $300 in 1972. For Year of Assessment 1977, only 1,992 taxpayers applied for remission. The tax remitted amounted to $161,865.

By and large, the objective of encouraging the proper maintenance of private gardens has been achieved. Many homes maintain attractive and clean gardens which make the living environment more congenial and pleasant. It is, therefore, unnecessary to continue with the tax remission for the maintenance of private gardens. I have decided with effect from the Year of Assessment 1978, to discontinue the tax remission.

### Taxes on Expenditure

To reduce the burden of income tax concessions on the Revenue, as well as to shift gradually the impact of taxation from incomes to consumption taxes, a number of taxes on expenditure will go up.

### Additional Registration Fee on Private Motor-Cars

With immediate effect, the Additional Registration Fee rate for private motor-cars will be increased from 100 percent to 125 percent ad valorem. The Preferential Additional Registration Fee will also be correspondingly increased to 125 percent of its present rate for each class of vehicle.

The additional revenue yield is estimated at $14.4 million. The additional tax is most necessary if we are to prevent the release of $54 million freed by the new income tax rates for the lower and middle income groups from going into private cars excessively, once again cluttering up the roads.

### Entertainments Duty

With effect from April 1, 1978 the duty rate for cinemas, amusement parks, trade fairs and exhibitions will increase from 20 cents to 25 cents for every increase of 50 cents or part thereof for admission charges exceeding $1.50.

The duty rate for "live" entertainment such as stage plays, concerts, recitals, music performances and dances will also increase by 5 cents for tickets priced at $1.00 or more. The duty payable will be 25 cents for admission priced at $1.00 to $1.50 and an additional 15 cents for every subsequent increase of 50 cents or part thereof.

The rates for establishments which pay lump sum entertainments duty and provide floor shows, music and dance facilities will increase by 20 percent.

Games and sports, including professional boxing and wrestling, as well as roadside wayangs, will not be subject to the increase in entertainments duty.

It is expected that the increase will net additional revenue of $7.5 million.

## Driving Licence Fees

The last revision in the driving licence fee was in 1966. With effect from April 1, 1978, the fee will be increased from $10 to $20 a year. The provisional driving licence fee will also be raised from $10 to $20 for six months. That fee has not been revised since 1963.

The revisions are expected to yield and additional $11.6 million.

## Telephone Tax

The Government tax on telephone bills has not been revised since 1969. From April 1, 1978, the rate will be raised from 15 percent to 20 percent. The scope of the tax remains unchanged, that is, it will be levied on domestic telephone services and on trunk calls to West Malaysia.

The additional yield expected is $5.7 million a year.

## Colour TV Licence Fee

Although transmission of television programmes in colour started three years ago, the licence fee for colour television sets was left at $36 a year. Transmission of colour TV calls for heavy investment in facilities as well as in substantially increased levels of operating expenditure. With more programmes now being telecast in colour, the time is appropriate to differentiate between colour and monochromatic licence fees.

The fee for monochromatic sets will remain at $36 a year, but for colour sets will be raised to $54. The fee for radio will remain at $12 a year. A colour TV fee of $54 will cover all monochrome TV sets and radios in the same household.

For hotels, the concessionary rate of $18 a year will continue to apply for monochrome sets, but the rate for colour sets will rise to $27 a year.

The additional revenue yield is estimated at $1.5 million in the first year.

## Airport Tax

The existing rate of passenger service charge for flights to Malaysia and Brunei is $2 per passenger. I intend to raise the rate to $4 with effect from April 1, 1978. The extra revenue generated is expected to be $1.1 million in the first year.

The total yield from all these expenditure taxes is estimated at $41.8 million in the first year, and will reduce the loss to Revenue from the income tax concessions to $12.1 million a year.

## Tax on PUB Bills

One concession which I propose to give to consumers is

## TABLE C:

### TAX ON CHARGEABLE INCOME

| RESIDENT INDIVIDUALS | YEARS OF ASSESSMENT: 1961 to 1964 | | | 1965 | | | 1966 to 1977 | | | 1978 onwards | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| On the first | $ 1,500 | 5% | $ 75 | $ 2,500 | 6% | $ 150 | $ 2,500 | 6% | $ 150 | $ 2,500 | 5% | $ 125 |
| On the next | 500 | 6% | 30 | 2,500 | 9% | 225 | 2,500 | 9% | 225 | 2,500 | 8% | 200 |
| On the first | 2,000 | | 105 | 5,000 | | 375 | 5,000 | | 375 | 5,000 | | 325 |
| On the next | 1,000 | 7% | 70 | 2,500 | 12% | 300 | 2,500 | 12% | 300 | 2,500 | 10% | 250 |
| On the first | 3,000 | | 175 | 7,500 | | 675 | 7,500 | | 675 | 7,500 | | 575 |
| On the next | 1,000 | 8% | 80 | 2,500 | 15% | 375 | 2,500 | 15% | 375 | 2,500 | 12% | 300 |
| On the first | 4,000 | | 255 | 10,000 | | 1,050 | 10,000 | | 1,050 | 10,000 | | 875 |
| On the next | 1,000 | 10% | 100 | 5,000 | 20% | 1,000 | 5,000 | 20% | 1,000 | 5,000 | 15% | 750 |
| On the first | 5,000 | | 355 | 15,000 | | 2,050 | 15,000 | | 2,050 | 15,000 | | 1,625 |
| On the next | 2,000 | 12% | 240 | 5,000 | 23% | 1,150 | 5,000 | 23% | 1,150 | 5,000 | 20% | 1,000 |
| On the first | 7,000 | | 595 | 20,000 | | 3,200 | 20,000 | | 3,200 | 20,000 | | 2,625 |
| On the next | 3,000 | 15% | 450 | 5,000 | 25% | 1,250 | 5,000 | 25% | 1,250 | 5,000 | 25% | 1,250 |
| On the first | 10,000 | | 1,045 | 25,000 | | 4,450 | 25,000 | | 4,450 | 25,000 | | 3,875 |
| On the next | 5,000 | 18% | 900 | 10,000 | 30% | 3,000 | 10,000 | 30% | 3,000 | 10,000 | 30% | 3,000 |
| On the first | 15,000 | | 1,945 | 35,000 | | 7,450 | 35,000 | | 7,450 | 35,000 | | 6,875 |
| On the next | 10,000 | 25% | 2,500 | 15,000 | 40% | 6,000 | 15,000 | 40% | 6,000 | 15,000 | 35% | 5,250 |
| On the first | 25,000 | | 4,445 | $50,000 | | $13,450 | 50,000 | | 13,450 | 50,000 | | 12,125 |
| On the next | 10,000 | 30% | 3,000 | | | | 50,000 | 50% | 25,000 | 50,000 | 40% | 20,000 |
| On the first | 35,000 | | 7,445 | | | | $100,000 | | $38,450 | 100,000 | | 32,125 |
| On the next | 15,000 | 40% | 6,000 | | | | | | | 100,000 | 45% | 45,000 |
| On the first | 50,000 | | 13,445 | | | | | | | 200,000 | | 77,125 |
| On the next | 50,000 | | 25,000 | | | | | | | 200,000 | 50% | 100,000 |
| | $100,000 | | $38,445 | | | | | | | $400,000 | | $177,125 |
| | Over $100,000 @ 55% | | | Over $50,000 @ 50% | | | Over $100,000 @ 55% | | | Over $400,000 @ 55% | | |

by the abolition of the 5 percent on PUB bills which is now effective for consumption levels between $35 and $50 a month. With effect from April 1, 1978 only consumption levels of $50 and above will be subjected to tax at the same rate and as before, of 10 percent. The revenue loss is estimated at $5 million.

The total loss to Revenue from all the tax changes made in this Budget is approximately $17.1 million in the first year.

### Minister's Conclusion

The world economy has yet to recover from the shock of the oil crisis. The turbulence of the exchange rate of the US Dollar and the poor performance of the New York Stock Exchange are but some of the symptoms of the chronic problems of inflation and unemployment, leading to strong sentiments for trade restrictions and controls in most industrialised countries. Nevertheless, our growth rates of 7 and 7.8 percent over the past two years show what is still possible given prudent Government policies, efficient management and hard working and productive workers.

### SUMMARY

On March 13, 1978 the Finance Minister's Budget Statement was approved by Parliament after a debate by the Members in the House. Most Members supported the reductions in the rates of personal income tax while others suggested that a general reduction in company taxes is a simpler and more effective way of providing all-round stimulus to investment activity in Singapore.

Before the Budget Statement was passed by Parliament, a few Members complimented or criticised the various parts of the Statement while all of them generally approved the Government's economic and financial policy. The Budget was a pleasant and happy surprise to many.

For ease of reference, the following tables have been prepared:

Table A — Tax Changes At A Glace — 1978 Budget Statement.

Table B — Present And Revised Income Tax Rates on Individuals.

Table C – Tax on Chargeable Income:—

1961 to 1964

1965

1966 to 1977

1978 onwards.

## CANADA – SWITZERLAND TAX TREATY: WITHHOLDING TAX

Revenue Canada has issued a Press Release dated December 14, 1977 No. 77-16 announcing the conclusion of an administrative arrangement with Switzerland to complement the Canada-Switzerland Tax Treaty of August 19, 1977. This Press Release states that:

"The Honourable Joseph P. Guay, Minister of National Revenue, announced today that an administrative arrangement has been signed with Switzerland that will affect Canadians sending alimony payments, interest and dividends, pensions and a variety of other payments to residents of Switzerland.

The arrangement, which covers procedures for the withholding of non-resident tax, follows ratification of the Canada-Switzerland Tax Convention on August 19.

Under the Convention, tax rates on a number of payments have been reduced retroactive to January 1, 1976. The new withholding tax rates range from 10 percent on rentals of personal property to 25 percent on management fees and some alimony payments.

The Minister pointed out that under the new procedure, payors resident in Canada are permitted to withhold the treaty rates when paying or crediting income to an address in Switzerland without proof that the actual owner of the income is a Swiss resident. This is an exception to the usual requirement for a certificate of beneficial ownership before treaty rates are used.

The arrangement includes safeguards to ensure that the benefits of the reduced rates go only to persons entitled to them. When an agent or other financial institution in Switzerland receives income on behalf of someone outside Switzerland it will be the responsibility of the Swiss agent to withhold the additional Canadian tax on behalf of the person resident outside Switzerland. The additional tax withheld will be remitted to the Federal Tax Administration of Switzerland for forwarding to Revenue Canada, Taxation.

With the reduction in tax rates, Canadian taxpayers claining foreign tax credits will be limited to the new lower rates. Canadians who have paid tax to Switzerland in excess of the new limits are entitled to claim a refund from the Federal Taxation Administration of Switzerland by completing Swiss form R96. The claim must be filed within three years from the end of the calendar year in which the income became due. Similarly, residents of Switzerland who have paid excess Canadian tax may claim a refund from Revenue Canada, Taxation by filing an Application for Refund of Non-Resident Tax (Canadian Form NR7R). The claim must be filed within two years from the end of the calendar year in which the tax was paid.

An Information Circular, revising the current Circular on non-resident tax will be issued when further tax conventions are ratified. Additional information on non-resident withholding tax may be obtained from the Source Deduction section of the District Taxation Office."

# ZAMBIA:
# The Industrial Development Act 1977

The Pioneer Industries (Relief from Income Tax) Act 1965, which until recently regulated incentives to investment, has been repealed and replaced by the Industrial Development Act, 1977 (Act No. 18 of 1977), in force as from October 15, 1977.

## I. LICENSING UNDER THE ACT (Part II)

Persons intending to manufacture any product whether for sale in Zambia or abroad must obtain a licence to do so from the Minister concerned. Existing enterprises have six months in which to apply for such licence.

## II. INCENTIVES UNDER THE ACT (Part IV)

### A. *Incentives for priority enterprises*

Certain enterprises may be classified as priority enterprises and so be eligible for incentives under the new Act. An enterprise which satisfies two out of the following three criteria:

"(a) maximum utilisation of domestic raw materials;
(b) production of intermediate goods which are used by other industries;
(c) diversification of its industrial structure;"

and two out of these further three criteria:

"(d) creation of substantial opportunities for permanent employment;
(e) improvement of domestic industrial skills or fostering the development of domestic technology;
(f) promoting industrial development in rural areas."

may be classified as a priority enterprise. The incentives available to such enterprises are as follows:

(a) preferential treatment with respect to Government purchasing, unless the tender price submitted by such enterprise exceeds the lowest bid by ten per centum;
(b) preferential treatment with respect to the granting and processing of import licences;
(c) rebates on customs duty payable on capital equipment, raw materials and other intermediate goods where—
(i) in the case of capital equipment, labour intensive techniques of production are not a viable alternative;
(ii) in the case of raw materials, they are not available from domestic sources of supply;
(iii) in the case of intermediate goods, they do not inhibit the creation of domestic value-added;
(d) relief from sales tax in respect of the items described in paragraph (c), subject to the provisions of the said paragraph;
(e) relief from Selective Employment Tax, for such period as the Minister responsible for the administration thereof may prescribe;
(f) relief from Income Tax in such manner and for such period as the Minister responsible for the administration thereof may prescribe.

### B. *Incentives for exporting enterprises*

An enterprise which satisfies the Minister concerned that it exports a substantial portion of its products will be eligible for the following incentives:

"(a) relief from any tax or customs duty payable on the importation of machinery intended for use in the manufacture of such products or any other export product;
(b) relief from Income Tax, in such manner and for such period as the Minister responsible for the administration thereof may prescribe;
(c) favourable adjustment to export tariff rates, in such manner as the Minister responsible for the administration thereof may, in any particular case, determine;
(d) relief from import tariff in respect of raw materials, subject to such conditions and in such manner as the Minister responsible for the administration thereof may determine;
(e) preferential treatment with respect to the granting and processing of import licences."

### C. *Incentives for providing training facilities for Zambian citizens*

Any enterprise which provides such facilities or incurs expenses in training Zambian citizens may write off those expenses against income tax. The granting of employment permits to expatriate instructors hired for this purpose may also be eased:

### D. *Incentives for rural enterprises*

Enterprises located in a rural area will be eligible for the following incentives:

SUMMARY OF ZAMBIAN TAXATION

Income Tax: is payable on the income of individuals and legal entities receiving income from a source within or deemed to be within Zambia. Individuals and legal entities ordinarily resident in Zambia are also subject to income tax on dividends and interest from a source outside Zambia. Rates are as follows:

A. *Individuals:* income less exemptions and allowable deductions is subject to a graduated rate of income tax of 5 percent on the first K 500 ranging to 75 percent of the income in excess of K 12,000.

B. *Companies:* current rate 50 percent.

Death duties: are payable on death on the principal value in excess of K 15,000 of taxable property of which the deceased was at his death competent to dispose. Rates vary from 4 to 10 percent.

Customs duties: there are both ad valorem and specific duties, the rates vary from 5 to 50 percent plus a 10 percent temporary surcharge on all imports.

Excise duties: payable at specific rates on goods indicated in the tariff which are manufactured or produced in Zambia. The rate is charged per pound or per gallon as the case may be.

Stamp duty: payable on legal documents and instruments, the rate varies according to the nature and the value expressed in the document.

Sales taxes: are imposed on imported goods, goods manufactured locally and goods and services provided by hotels and restaurants. The rate is generally 10 percent, but may differ for certain locally manufactured goods.

Levies: Zambia imposes a number of levies on, for instance, dairy produce, agricultural products, African beer, tobacco and entertainment.

See for more details "African Tax Systems" (loose-leaf) published by the International Bureau of Fiscal Documentation.

"(a) eligibility to apply for loans from the Development Bank of Zambia;
(b) eligibility to purchase or apply for the rental of any factory or office facilities constructed in rural areas by Rucom, the Development Bank of Zambia or any other agency approved by the Minister responsible for rural development;
(c) the use of Rucom's marketing and extension services;
(d) the use of advisory services belonging to Rucom, the Development Bank of Zambia or any other agency approved by the Minister responsible for rural development, in project feasibility studies, accountancy, technology, marketing, and the choice of projects."

*E. Incentives for enterprises utilising foreign investment*

Enterprises which utilise investment provided from outside Zambia or employ, within Zambia, a significant amount of foreign capital will be eligible for the following:

"(a) a right to remit, on cessation of business interest, the value of such foreign capital or such investment, subject to the law relating to exchange control at the time of application for remittance;
(b) on making application therefor, an election to remit any accrued profits or dividends during the twelve-month period immediately following the end of the financial year to which the application refers, subject to any law relating to exchange control at the time of such application;
(c) any remittable profit which is reinvested in Zambia shall be credited to any amount which may be remitted on cessation of business;
(d) immunity from nationalisation unless the highest considerations of public interest so require."

*F. Incentives for research and development*

Expenditure incurred by or on behalf of an enterprise in respect of research and development will not be charged to tax.

## III. AGREEMENTS FOR THE TRANSFER OF TECHNOLOGY AND EXPERTISE (Part III)

The Act provides for the registration by the beneficiary of every such agreement with the Minister concerned. It also lays down conditions to be contained in these agreements as follows:

"(a) any royalties or fees charged shall bear a reasonable relationship to the use of such technology or expertise;
(b) any liability to pay royalties or fees shall cease upon the lawful termination of the agreement or if such technology or expertise becomes public knowledge otherwise than through the fault of the licensee;
(c) there shall be a reduction in royalties or fees if a third party acquires and uses such technology or expertise otherwise than through the fault of the licensee;
(d) any technical assistance shall, where necessary, include technical personnel as well as full instructions and practical explanations expressed in clear and comprehensive English on the operation of any equipment involved;
(e) the transferor shall provide technical assistance in connection with marketing programmes and purchasing of equipment involving the use of such technology or expertise;
(f) the transferee shall acquire the right to continued use of such technology or expertise after the termination of the agreement;
(g) the transferor shall, if the transferee so requires, continue to supply spare parts and raw materials for a period of up to five years following the termination of the agreement;
(h) subject to the directions of the Minister, the transferee shall enjoy the benefits and privileges of the most favoured licensee."

and those which may not form part of such an agreement. Thus, the following are not allowed: any condition

"(a) which restricts the use of competitive techniques;
(b) providing for any form of control over the management of the licensee's enterprise;
(c) which restricts the manner of sale of products or the export of products to any country;
(d) which restricts the sources of supply of inputs;
(e) which restricts the volume or structure of production;
(f) which limits the ways in which any patent or other know-how may be used;
(g) which provides for the payment of royalties or fees in foreign currencies or outside Zambia, except with the prior approval of the Bank of Zambia."

The Act also gives the Minister concerned power to regulate the payment of royalties or fees and the conditions under which technical assistance may be negotiated or accepted.

# CONFERENCE DIARY

## MAY 1978

*British Branch of I.F.A.:* Anglo-U.S. Seminar, London (U.K.), May 4 and 5 (English).

*The International Tax Planning Association:* Annual Conference (subjects include: taxation in the Caribbean, offshore structures, trusts, change of residence, international transactions and measures taken by Governments to counter tax avoidance).

*Belgo—Luxembourg and French Branches of I.F.A.:* Seminar on the tax treaties concluded between Belgium, France and Luxembourg, Paris (France), May 19 (French).

*Dutch—German Branches of I.F.A.:* International Tax Seminar (permanent establishment, construction activities, arm's length dealing, international aspects of the new German imputation system, fiscal unity for VAT purposes, new developments in the E.E.C.), Hamburg (German Federal Republic), May 19 and 20 (German).

*Marchmont Conferences:* International Tax Planning Conference (including: the key role of tax treaties, tax haven activities, maximising the net-of-tax remuneration of expatriate executives). Barbados, May 23-26 (English).

*European Study Conferences Limited:* Double Taxation — Taking Advantage of International Agreements, Guernsey Channel Islands (U.K.), May 25 and 26 (English).

## JUNE 1978

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), June 19-21 (English).

## SEPTEMBER 1978

*32nd Annual Congress of I.F.A.:* I. The Taxation of Extractive Industries; II. The Differences in the Tax Treatment between Local and Foreign Investors and the Effects of International Treaties. Sydney (Australia) September 17-23 (English, French, German, Spanish).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (Seminar), Brussels (Belgium), November 7-8 (English).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Australian Branch of I.F.A.: Bank of New Zealand House, 12th Fl. 333 George Street, Sydney 2000 (Australia).

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

Business International Institute: One Dag Hammarskjold Place, New York, N.Y. 10017 (U.S.A.).

European Study Conferences Limited: Kirby House, 31 High Street East, Uppingham, Rutland, Leics. LE15 9PY. (United Kingdom).

Financial Times Ltd. Conference Organisation: Bracken House, 10 Cannon Street, London EC4P 4BY (United Kingdom).

German Branch of I.F.A.: Secretariat Oberländer Ufer 84-88, 5000 Cologne 51 (German Federal Republic).

Inter-American Centre of Tax Administrators: Apartado 215, Panamá 1 (Panama).

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

The International Tax Planning Association: c/o Investment and Property Studies Ltd., Norwich House, Norwich Street, london EC4A 1AB (U.K.).

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

Belgium/Luxembourg Branch of I.F.A.: Secretariat Avenue Louise, 385, Bte. 1, 1050 Bruxelles (Belgium).

Netherlands Branch of I.F.A.: Secretariat Alexander Gogelweg 30, 2502 LS Den Haag (The Netherlands).

Marchmont Conferences: Vogue House, 1 Hanover Square, London W1R 9RD (United Kingdom).

Seminar Services International: 21-23 Chilworth Street, London W 2 3HW (United Kingdom); Passage Perdonnet 1, CH-1005 Lausanne (Switzerland).

**INDIA:**

# Finance Bill 1978 ~

## SUMMARY OF IMPORTANT CHANGES PROPOSED

by Kailash C. Khanna*

## DIRECT TAXATION

### 1. PERSONAL TAXATION

(a) It is proposed to amend the relevant provision relating to the status of "ordinary residence" in the case of an individual who is a citizen of India and who is rendering service outside India so as to enable him to spend a period not exceeding 89 days while on leave or vacation in the country without incurring liability to Indian tax on foreign income.
The intended provision will apply only to those individuals whose service outside India has been sponsored by the Central Government or the terms and conditions of such service have been approved by the Central Government or the prescribed authority.
The proposed amendment will apply to 1979/80 and subsequent assessment years.

(b) Income from let-out residential property constructed after March 31, 1978 is proposed to be free of tax to the extent of an annual value of 2,400 Rs. for a period of five years from the date of completion of the building.

(c) At present, capital gains arising from the transfer of long-term capital assets are exempt from tax if the consideration for transfer is invested in specified financial assets within a period of six months of the transfer. The specified assets include shares in Indian public companies and deposits for a minimum period of three years with nationalised banks. It is proposed to exclude these two assets, subject to the following exception, from the scope of specified assets in regard to transfers made on or after March 1, 1978.
It is intended to provide that investment after February 28, 1978 in shares in an Indian company will qualify as investment in a specified asset only where such shares form part of an "eligible issue". The main conditions to be satisfied by an "eligible issue" are

(i) the issue should be made by an Indian public company engaged in construction, manufacture or production of articles, excluding low-priority articles; and
(ii) the shares should form part of the initial issue of capital by the said company offered for public subscription.

Other conditions may be prescribed. The initial issue of equity shares of a private company converted into a public company will not be regarded as an "eligible issue" if the company has declared any dividend as a private company or the shares are offered for subscription at a premium.
The investment in the "eligible issue" shall be made by the individual either in pursuance to an offer for public subscription or by purchase from an underwriter as such.

(d) It is proposed that an individual subscribing to shares in an "eligible issue", as described in the last clause, be entitled to a deduction from his taxable income of an amount equal to 50 percent of the cost of the shares so subscribed, subject to a maximum cost of 10,000 Rs. with effect from the assessment year 1979/80. The individual will be required to hold the said shares for a period of five years and the tax concession will be forfeited if the shares are transferred before the end of the aforesaid period. Investment in equity shares in an "eligible issue" which has enjoyed tax relief under this clause shall not be taken into account for the purpose of the concession from capital gains tax referred to in the immediately preceding clause (c).

(e) It is proposed to increase the quantum of the deduc-

**HIGHLIGHTS OF THE FINANCE BILL 1978**

- No change in the rates of income-tax, wealth-tax and other direct taxes;
- The provisions with respect to long term capital gains taxation will be amended;
- The provisions relating to the deduction of life insurance premiums and provident fund contributions will be liberalised;
- Taxpayers investing in shares of certain industrial companies will be entitled to a 50 percent investment deduction;
- The rates of the compulsory deposit will be increased;
- The initial depreciation allowance for housing of low paid employees will be increased;
- Part of expenditure on publicity will be disallowed;
- The export market development allowance will be abolished;
- Indirect taxes will be increased.

* Kailash C. Khanna & Co., Chartered Accountants, Calcutta, India.

tion allowable in respect of life insurance premia, provident fund contributions etc., from the assessment year 1979/80. The suggested increase will permit a deduction of the whole of the first 5,000 Rs. as against the existing 4,000 Rs.; 50 percent of the next 5,000 Rs.; and, as regards the balance, 40 percent thereof will be deductible subject to an aggregate monetary ceiling of 30,000 Rs. instead of the present 20,000 Rs.

## 2. COMPULSORY DEPOSITS

The rates of compulsory deposits to be made in the financial year 1978/79 are proposed to be increased and the suggested rates are

| | |
|---|---|
| 15,001 – 25,000 Rs. | 4.5 percent |
| 25,001 – 35,000 Rs. | 11 percent |
| 35,001 – 70,000 Rs. | 12.5 percent |
| Above 70,000 Rs. | 15 percent |

## 3. ESTATE DUTY

The exemption limit from Estate Duty is proposed to be raised fom 50,000 Rs. to 100,000 Rs., but the necessary legislation in this respect will be moved later.

## 4. CORPORATE TAXATION

(a) With effect from the assessment year 1979/80, initial depreciation admissible in respect of new buildings constructed for housing low-paid employees having income from "salaries" up to 10,000 Rs. is proposed to be increased from 20 percent to 40 percent.

(b) It is intended to allow as a deduction from total income, with effect from June 1, 1978, any expenditure by way of payment of any sum to an approved association or institution for carrying out an approved programme of rural development.

(c) It is proposed to disallow a part of the aggregate expenditure on advertisement, publicity and sales promotion in India in the computation of taxable income if such expenditure exceeds 20,000 Rs. in the relevant previous year. The suggested disallowance is 10 percent, 12.5 percent and 15 percent of the "adjusted expenditure" depending upon the percentage — up to ¼ percent, above ¼ percent but up to ½ percent and above ½ percent — which the aggregate expenditure on advertisement etc., bears to turnover or the gross receipts of the business. "Adjusted expenditure" broadly means net expenditure on advertising etc., allowable under the existing provisions of law.

In the case of an industrial undertaking newly set up no disallowance shall be made of any expenditure on advertisement, publicity or sales promotion for a period of three accounting years beginning with the accounting year in which the undertaking commences manufacture. The above provision is proposed to be inserted from April 1, 1979 and will cover the stipulated expenditure incurred during the whole of the previous year relevant to the assessment year 1979/80.

(d) The existing weighted deduction in respect of export market development allowance is proposed to be withdrawn from April 1, 1978 with the result that only actual expenditure incurred on export market development will qualify as a deduction from total income after March 31, 1978.

## 5. GENERAL

At present, existing assessees pay advance tax or send an estimate after a notice of demand is received from the Income-tax Officer. It is proposed to modify existing provisions so that every taxpayer, whether he has been assessed or not, will have to pay advance tax voluntarily in case his income liable to advance tax exceeds the specified limits. The Income-tax Officer may, however, still issue Demand Notices in such cases as he considers necessary.

# EXCISE DUTIES*

The following amendments have been proposed:

1. Coal will be subject to an excise duty of 5 Rs. to 10 Rs. per tonne and electricity to a duty of 2 paise a kilowatt-hour.
2. The general levy under the residuary heading 68 of the Central Excise Tariff will be increased from 2 to 5 percent ad valorem.
3. A special duty at the rate of 5 percent of the effective rate of excise duty due on all gods will be introduced.

**EXEMPTION FOR POLITICAL PARTIES**

*The Government of India have decided to provide exemption from income-tax in respect of certain categories of income derived by political parties, as also exemption from wealth-tax in respect of the value of assets held by them. Income derived by political parties from their investments (both in movable and immovable properties) and income by way of donations from non-members will be exempted from income-tax. The tax exemption will be available only in the case of political parties which are registered or deemed to be registered with the Election Commission of India under the Election Symbols (Reservation and Allotment) Order, 1968.*

*The proposed exemption will not be allowed unless the political parties maintain proper books of accounts and get their annual accounts audited by a chartered accountant or other qualified accountant.*

*Political parties which are registered or deemed to be registered with the Election Commission of India will also be exempted from wealth-tax.*

*Expenditure incurred by tax-payers for advertisement in any souvenir, brochure, tract, pamphlet or other publication of a similar nature published by a political party will not be deducted in computing their taxable profits.*

* Prepared by the International Bureau of Fiscal Documentation.

4. Special relief from excise duty for the agricultural sector: exemption from excise duty on power, pumps, pesticides and the like.
5. Exemption and relief for small units and also with respect to certain goods such as milk powder, three-wheeler auto-rickshaws used as taxis, small refrigerators and air conditioners used for special purposes (hospitals, laboratories etc.).
6. Exemption for newspapers, drugs, medicines and pharmaceuticals.

## CUSTOMS DUTIES

Customs duty relief is proposed for condenser and tissue paper.
Import duty on polyester yarn will be increased from 120 percent to 200 percent and ad valorem. This will yield 6.4 crores Rs. annually.
Customs duty on specified capital equipment not produced indigenously is reduced from 40 percent to 25 percent. The loss of revenue will be 9 Rs. crores.

# BUDGET SPEECH 1978

On February 28, 1978 the Indian Finance Minister, Mr. H.M. Patel pronounced his Budget Speech which is partly reproduced hereafter. Mr. Patel stated that the deficit of 1,396 crores Rs. (1 crore = 10 million) placed a heavy responsibility on his shoulders but that it would not create inflationary conditions. He enumerated the tax policy principles of the Janata Party which were issued in November 1977, i.e.

"We believe that the taxation policy of the government must keep in mind five considerations:
1) Increased public investment expenditure must necessitate increased public income. The people of the country, therefore, have to accept the burden of higher taxation in the future.
2) Taxation policy must simultaneously aim at redistributive justice and must take into consideration the capacity to pay.
3) Taxes should be easy to collect and it should be easy for the taxpayer to know what he has to pay. There is urgent need for the simplification and rationalisation of the tax administration.
4) Taxes must have an in-built growth potential and inherent buoyancy.
5) Taxation policy must aim at stimulating national growth and must encourage production and savings."

Mr. Patel further stated that:

Members will recollect that the Janata Party manifesto had contained a promise that the question of removing sales tax and octroi duties would be duly considered by the government. I have had a series of discussions with the chief ministers and finance ministers of the states to achieve this desirable objective. The total revenue from sales tax is of the order of 2,500 crores Rs. And it is growing steadily. It constitutes the main source of revenue of the states. The chief ministers of the states have generally showed a lack of enthusiasm for the abolition of sales tax. In view of the attitude of the states and since sales tax is a state subject, the task of persuading the states to give up sales tax calls for persistence and patience. It certainly cannot be regarded as something which can be accomplished in the immediate future.
The octroi duty, however, stands on a different footing. The revenue from octoi duty is of the order of 250 crores Rs. There has been a long standing demand for the removal of this obnoxious levy which causes great inconvenience to trade and transport industry. All committees which have gone into the subject have unanimously proposed its abolition. Studies have also revealed that the cost of collection of the octroi duty is unduly high. There can be no two opinions that the removal of octroi duty will be widely welcomed since its abolition will assist the orderly and healthy growth of the transport system in the country and will considerably reduce freight costs. I therefore propose to request the state governments to introduce suitable legislation for the removabl of octroi. The octroi revenues are at present going to the local authorities. Quite understandably they will seek from the state governments a reimbursement for the loss of revenue and in turn the state governments will no doubt claim a measure of compensation from the Centre. We shall hold discussions with the state governments for finding a satisfactory solution.

...

I shall now deal with my proposal in the sphere of direct taxes.
I have kept in view the fact that a substantial increase in investment has necessarily to be backed by increased efforts at mobilisation of savings. My proposals in the field of direct taxes are accordingly designed to promote larger savings: To curb extravagant and wasteful expenditure in business and professions, and to channelise funds for stimulating growth and production. I have also sought to provide some tax relief in selected areas with a view to encouraging larger investment in desired directions.
In order to mobilise additional resources in the form of savings, I propose to raise the rates of compulsory deposit in the case of income-tax payers. While taxpayer having current income up to 15,000 Rs. will continue to enjoy immunity from the requirement of making compulsory deposit, in the case of incomes exceeding 15,000 Rs. and up to 25,000 Rs. the rate will be raised from 4 percent to 4½ percent. On the slab of 25,001 Rs. to 70,000 Rs., compulsory deposit is currently made at the rate of 10 percent. I propose to split this slab into two. While the rate on the slab of 25,001 Rs. to 35,000 Rs. will be 11 percent the rate on the slab of 35,001 Rs. to 70,000 Rs. will be 12½ percent. On the slab over 70,000 Rs. the rate will be raised from 12 percent to 15 percent. Approximately 25 crores Rs. will accrue in 1978-79 as a result of this measure.
I propose to liberalise the concession in respect of long-term savings through life insurance, provident fund contributions and other approved forms of savings. At present, 100 percent of the first 4,000 Rs. of the qualifying savings, 50 percent of the next 6,000 Rs. and 40 percent of the balance is allowed as deduction in computing the taxable income. I propose to allow a deduction equal to 100 percent of the first 5,000 Rs. of the qualifying savings. The quantum of deduction in respect of the next 5,000 Rs. will continue at the existing rate of 50 percent and, in respect of the balance, at the existing rate of 40 percent. The monetarly limit for the savings qualifying for deduction under this provision is also being raised from 20,000 Rs. to 30,000 Rs. These measures will result in a revenue loss of 10 crores Rs. in a full year and 7.5 crores Rs. ub 1978-79.
Investors understandable preter investment which brings them a sale return, which is provided by fixed deposits in banks or shares of established companies with a good record for payment of dividends. This results in new companies not attracting adequate support. In order to stimulate such investment, I propose to give a deduction in the computation of taxable income of 50 percent of the amount invested in equity shares of new industrial companies. The maximum investment in a year qualifying for this deduction will be limited to 10,000 Rs. This will entail a loss of crores Rs. in a full year and 3.5 crores Rs in 1978-79. I would cheerfully accept a much larger loss if it results in stimulating larger investments.

Last year, I had introduced a provision to exempt capital gains in cases where the sale proceeds arising from the transfer of an asset are reinvested within six months in units of the Unit Trust of India, shares of Indian companies, bank deposits and other specified assets. In order that this consession leads to the flow of investible fund into fresh ventures, I propose to provide with immediate effect that investment in shares of Indian companies will be taken into account for the purposes of exemption from capital gains tax only where the investment is made in equity shares of new industrial companies.

Banks allow substantial advances against the security of fixed deposits with them. Hence, taxpayers who get exemption from capital gains tax by making such deposits, obtain an unduly large tax benefit without commensurate sacrifice. I have, therefore, decided that fixed deposits with banks made after today will not qualify as an eligible mode of investment for the purpose of this exemption.

The annual letting value of a newly constructed house is reduced for tax purposes by an amount upto 1,200 Rs. in respect of each residential unit for a period of five years. With a view to providing a stimulus for construction of houses, particularly for persons in the low and middle income brackets, I propose to raise the monetary limit of 1,200 Rs. to 2,400 Rs.

Initial depreciation allowance is currently granted at the rate of 20 percent on the cost of new buildings erected by employers for their low paid employees.

In order to give a greater impetus to the construction buildings for workers, I propose to increase the rate of initial depreciation allowance from 20 percent to 40 percent.

The foreign remuneration of Indian citizens employed outside India is liable to Indian income-tax if their stay in India exceeds a specified period. As this results in avoidance hardship and discourages such persons from spending even a reasonable period on vacation in their home country, I propose to provide that Indian citizens employed outside India may stay on vacation in the country for 89 days in a year without attracting such tax liability.

In order to ensure that winnings from horse races are effectively brought within the tax net, I propose to provide for deduction of tax at source at the rate of 34.5 percent from winnings in excess of 2,500 Rs. This measure would yield 4 crores Rs. in a full year and 3.5 crores Rs. in 1978-79.

Extravagant and socially wasteful expenditure is often incurred on advertisement, publicity and sales promotion. In order to put a curb on such expenditure at the cost of the exchequer, I propose to provide for the disallowance of a part of such expenditure on advertisement, publicity and sales promotion in India. Where the aggregate expenditure does not exceed 1/4 percent of the turnover of gross receipts of the business or profession, 10 percent of such expenditure will be disallowed in computing the taxable profits. Where such aggregate expenditure exceeds 1/4 percent but does not exceed 1/2 percent of the turnover or gross receipts, the disallowance will be made at the rate of 12.5 percent; and where such expenditure exceeds 1/2 percent of the turnover or gross receipts, the disallowance will be made at the rate of 15 percent. These provisions will not apply in cases where the aggregate expenditure on advertisement, publicity and sales promotion does not exceed 20,000 Rs. in a year. Newly-established industrial concerns will also be exempted from this provision for an initial period of three years. This measure will yield 32 crores Rs. in a full year and about 25 crores Rs. in 1978-79.

A weighted deduction is currently allowed in the computation of taxable profits with reference to expenditure incurred by Indian companies and resident taxpayers, other than companies, on development of export markets. The weighted deduction is allowed at the rate of 150 percent of the actual expenditure in the case of widely-held companies and at the rate of 133.3 percent in the case of other taxpayers, while the full deduction of expenditure incurred for development of export markets is entirely justifiable, and no part of such expenditure will be disallowed under the proposed provision for disallowance of expenditure on advertisement, publicity and sales promotion. I do not see adequate justification now for continuing to subsidise such expenditure by the grant of weighted deduction. I, therefore, propose to discontinue the grant of weighted deduction in relation to such expenditure incurred after March 31, 1978. This measure is likely to yield 10 crores Rs. in a full year and 8 crores Rs. in 1978-79.

In the case of a taxpayer who has previously been assessed to income-tax, advance tax becomes payable only if a notice in this behalf is issued by the income-tax officer. Hence, if an advance tax notice is not issued in the case of such a taxpayer, he will have no liability to pay any advance tax. On the other hand, taxpayers who have not been assessed to income-tax, are required to pay advance tax on their own on the basis of their estimated current income. To my mind, the existing legal position is clearly unsatisfactory. I, therefore, propose to provide that advance tax shall be voluntarily paid by every person if his current income exceeds the specified limit.

The direct tax laws committee under the chairmanship of Mr. C.C. Chokshi submitted its interim report last December. The report contains a number of valuable suggestions for simplification and rationalisation of tax laws, streamlining assessment procedures, reducing the area of litigation and accelerating the disposal of appeals and references. In its report on the Central direct taxes administration, the Administrative Reforms Commission had recommended that amendments to the tax laws should not be rushed through the annual finance Bill, which needs to be passed before a prescribed date, but made through separate Bills whose provisions can be considered in detail.

Pursuant to this recommendation, I propose to introduce separate legislation as early as possible to five effect to the main recommendations of the Chokshi Committee which are acceptable to the government. In the meanwhile a few changes recommended by the committee, such as deduction of tax at source from race winnings and voluntary payment of advance tax, which could be easily incorporated in the tax law, have been introduced through the finance Bill.

The exemption limit for estate duty, which is 50,000 Rs. was fixed as long ago as 1958. As this exemption limit is induly low, I propose to raise it to 1 lakh. Rs. Since, in this matter, we can move only with the concurrence of the state legislatures, a Bill for implementing this proposal, and certain other proposals in relation to estate duty, will be introduced later this year.

The total additional revenue from the various measures enumerated by me will yield 30 crores Rs. in a full year and 25.5 crores Rs. during 1978-79. Besides, additional resources of about 25 crores Rs. will accrue in the form of compulsory deposits in the financial year 1978-79.

May I now turn to my proposals relating to indirect taxes? Our basic national problem, and indeed this is a problem facing all developing countries, is that the base for direct taxes is extremely narrow and the vast funds required for national development cannot, therefore, be raised, at our present stage of development, from direct taxes alone. While framing the proposals relating to indirect taxes, however, I have kept in mind the need to protect small-scale industry and to minimise the hardship to the poor and the middle class consumers.

Hon'ble members are aware that government had appointed a committee, to review the existing structure of the indirect tax system, under the chairmanship of Mr. L.K. Jha. The committee has now submitted its final report. Amongst the important recommendations made by the committee are restructuring of the pattern of Central excise and customs duties, measures to assist the small-scale sector, the general reorientation of the tariff to make it income-elastic and the desirability of introducing a value added tax so as to avoid the cascading effect of taxes on raw materials and components of finished products. The committee has also made some recommendations with the care which they deserve. In may last budget, I had in fact accepted and implemented a few of the recommendations which were available to us in the interim report of the committee. The proposals which I am making today incorporate some of the recommendations made in the final report. Other recommendations which involve a major restructuring of the system would require further study.

In the plan outlay, the topmost priority has been accorded to power. The plan provision for power generation and distribution is of the order of 2,200 crores Rs. in 1978-79. I feel that with our enormous investments in power, there is ample justification for claiming a contribution from those who benefit from these investments. I am, therefore, proposing to levy a duty of 2 paise per kilowatt-hour on electricity generated. Electricity generated for captive consumption, as well as that used in the auxiliary plants in the generating stations for the generation of electricity, is being exempted. I also propose to give a rebate of the duty to the producer in respect of electricity used for agricultural purposes so that agriculturists are not effected. This levy is expected to yield a revenue of 145 crores Rs.

After the nationalisation of the coal mines, coal production has increased from about 72 million tonnes in 1971-72 to about 100 million tonnes in 1976-77. This is the result of enormous investments made by the state after nationalisation — investments which we will continue to make. Here again, the beneficiaries could, I think, justifiably be called upon to bear a small levy of Central excise duty on coal. I propose to fix this at rates varying from 5 Rs. to 10 Rs. per tonne. The lowest rate of 5 Rs. would cover three fourth of the coal produced in the country. This measure is expected to yield a revenue of 58 crores Rs.

Under item 68 of the Central excise tariff, the rate of duty leviable on "all articles, not elsewhere specified" is at present 2 percent ad valorem. I propose to raise this to the level of 5 percent ad valorem. While doing so, I propose to exempt some sensitive categories of goods, namely, pesticides, weedicides, insecticides and fungicides, drugs and medicines other than proprietary or patent drugs and medicines, pharmaceuticals and drug intermediates, from the whole of the duty leviable under this item. Newspapers and periodicals are also being exempted completely. The existing exemption in respect of small manufacturers whose clearance of excisable goods does not exceed 30 lakhs Rs. in the preceding year, will continue. These proposals will yield a revenue of 100 crores Rs.

In view of the paramount need for mobilising resources for development without creating fresh distortions in the tax structure, I propose to levy a special duty at the rate of 1/20th of the basic excise duties presently collected on each item in the Central excise tariff. In doing so, I propose to exempt coal, electricity and goods which are assessed under item 68 of the tariff. This measure will result in an additional revenue of 214 crores Rs. on indigenous production and a sum of 15 crores Rs. by way of increase in countervailing duties on imports.

May I now turn to the relief which I propose to give. First of all, consistent with the policy of the government to encourage the small manufacturer and to widen the entrepreneurial base in the country, I propose to provide sufficient relief to small manufacturers so as to enable them to compete successfully with larger units. The duty exemptions at present available to small-scale manufacturers are not based on any one pattern. Over the course of years, a number of *ad hoc* concessions have been given and the principles of relief have varied very widely. In defining the small units, a variety of formulae have been adopted, such as value of clearances per annum, quantity of clearances per annum, value of capital investment on plant and machinery, number of workers, use of power, and a combination of two or more of these criteria. Keeping in view the need for rationalising the pattern of relief to small industries and bearing in mind the recommendations made by the Jha Committee, I propose to exempt all small-scale units manufacturing specified goods, whose clearances in the preceding year did not exceed 15 lakhs. Rs. from the duty payable on the first clearance of 5 lakhs. Rs. The exemption will cover, amongst others, medicines, soap and detergents, paints and varnishes, household electrical goods, steel furniture, metal containers, aerated waters, vegetable non-essential oils, ceramics and other item notified. This measure will benefit about 24,000 units currently under excise control. It will reduce considerably the procedural requirements which these units are required to follow. It will also remove the anomaly, under which relief is presently lost totally in many cases, the moment the threshold limits of exemption are crossed. This relief will be effective from the beginning of the next financial year and involve a revenue sacrifice of 28 crores Rs.

I propose to exempt power-driven pumps mainly used in agriculture, from the whole on the excise duty leviable thereon. The measure will involve a loss of 1.5 crores Rs. per annum.

Also I propose to extend the concession available to motor vehicles used as taxis to three-wheelers and auto-rickshaws as well by reducing the rate of duty leviable on the latter by 2.5 percent ad valorem. Whole milk powder is being exempted from payment of the duty leviable thereon in an effort to make available this commodity at a cheaper rate. I also propose to reduce the rate of duty leviable on small refrigerators of capacity of 100 litres and less from 40 percent ad valorem at present to 30 percent ad valorem. At present, parts of refrigerating and air-conditioning machinery required for installation in specified establishments are assessed at a concessional rate of 20 percent. This concession is being extended to ready-assembled air-conditioning units of the window and package type, generally used by smaller industrial installations.

Last year I had raised the excise duty on films substantially. There have been a number of representations against the increase and the manner in which it affects the industry. I have carefully considered the matter and propose to reduce the excise duty leviable from 7,500 Rs. to 5,000 Rs. on the third-dozen slab of colour prints of length 4,000 metres or less. Suitable adjustments are being made in the case of black and white films as well as longer films. Duty on prints cleared for home consumption after twelve months from the date of first release of the film for public exhibition is also being reduced suitably. These proposals together imply a relief of about 3 crores Rs.

In pursuance of government's decisions on the Oil Prices Committee's report, the tariff structure relating to lubricating oils and greases has also been rationalised. This measure of rationalisation will yield 63 lakhs Rs. net in a year.

I have also carried out some modifications in respect of coated fabrics, cigars and cheroots, tea waste, vegetable products for industrial purposes and non-cellulosic wastes, the details of which are given in the budget documents. These proposals will yield a revenue of 6 crores Rs.

I have taken note of the sginificant suggestions in regard to customs duties made by the Jha Committee. As a measure of relief and particularly with a view to bringing down capital costs, I propose to reduce the customs duties on specified items of capital equipment not produced indigenously from the current level of 40 percent to 25 percent. The revenue loss will be of the order of 9 crores Rs.

I also propose to reduce the duty leviable on condenser tissue paper and polypropylene films used in the manufacture of capacitors, by 111 percent and 155 percent respectively. Use of capacitors will reduce transmission losses and will thus help the more efficient transmission of power. Duty on electrical insulation paper is also being reduced. These proposals will involve a revenue sacrifice of about 4 crores Rs.

Certain reliefs are also being given in respect of specified items of cinematograph machinery, electronic components and imported feature films. These together will involve a revenue sacrifice of 58 lakhs Rs.

I have only one proposal for upward modification of the customs tariff, not so much as a measure of raising revenue but as a measure of protection to Indian industry, I propose to increase the import duty on polyester filament yarn from 120 percent to 200 percent ad valorem. This will yield about 6.4 crores Rs. in a year.

My proposals for customs and Central excise duties put together will yield an additional revenue of 499 crores Rs. for 1978-79.

The fiscal stategy underlying my proposals seeks to take advantage of the favourable good and foreign exchange situation for generating fresh expansionary impulses in our economy. The big step-up in public investment is one element of this strategy. Monetary policy must also be used to reinforce fiscal policy.

The House will recollect that government had imposed a tax in 1974 on interest income of banks. Hon'ble members will agree with me that, now that prices are reasonably stable and there is urgent need to stimulate productive investment, this tax has lost its economic justification. I proprose, therefore, to withdraw the interest-tax with immediate effect. As a sequel to this fiscal concession with a monetary intent, the Reserve Bank of India will be announcing later in the day the realignment of the interest rate structure.

The budget estimates for 1978-79 have taken credit for an amount of 130 crores Rs. on account of interest-tax. Since the interest-tax for the months of January and February 1978 will be payable in the coming year, the actual loss of revenue will be of the order of 108 crores Rs.

To sum up, my efforts at mobilisation of additional resources will yield in 1978-79 549.5 crores Rs., of which 499 crores Rs. will be from Union excise and customs duties, 25.5 crores Rs. from direct taxes and 25 crores Rs. as compulsory deposits. Out of this, the states' share will be 95.5 crores Rs. and the Centre's share 454 crores Rs. With the withdrawals of interest-tax, the additional resources accruing to the Centre will be 346 crores Rs.

Despite the effort which I have made at raising additional resources, I am leaving an uncovered budgetary gap of 1,050 crores Rs. This figure will be reduced by the receipts from sales of government gold. For reasons which hon'ble members will appreciate, I shall not attempt to estimate this figure. But I should share with hon'ble members the view I hold that, apart from preventing any resurgence of gold smuggling, it is also justifiable, in our present circumstances, to utilise a part of our accumulated gold to reduce the expansionary effect of budgetary transactions. It is on the same reasoning that we have been anxious to deploy a part of our foreign exchange reserves to offset the expansionary impact of larger plan and investment outlays, and I am confident that in the coming year the steps initiated to liberalise imports and the major investment programme that we now propose to undertake, will lead to a significant draw-down of foreign exchange reserves. These two factors combined with continued vigilance regarding credit should limit the net increase in money supply to safe levels.

I am satified that the resultant monetary expansion will not lead to any inflationary pressures particularly in view of the large stock of food-grains and the much greater ability that we have at present to import essential consumer goods.

The experience we have gained and the investments we have forged in supply management through procurement and public distribution and demand management through credit and monetary policy should also enable us to contain such pressures.

In conclusion, let me summarise what I seek to achieve through this budget. My goal is to set in motion a process of sustained increase in output and employment, particularly in the rural areas. The programme of government expenditure on investment is the main instrument I wish to use to attain this goal. Investment expenditure in infrastructure facilities is being raised steeply so that bottle-necks coming in the way of further growth are removed and there is an improvement in the general economic climate. This has made it necessary for me to undertake sizable additional resource mobilisation. At the same time, I have not hesitated to offer incentives and tax concessions where these are called for to promote investment in agriculture and industry.

The economic situation of the country is exceptionally favourable at present for a bold step forward. This budget is such a step.

# TAX GLOSSARY

by H.W.T. PEPPER *

**EQUITY HOLDING COMPANY** — (Belgium) Company which holds ordinary shares in others, as a holding company or parent company. In Belgium, for example, a trading and industrial company is exempt from tax on 95 percent of equity dividends received. The position is similar in France, and some countries give complete exemption — in all cases to avoid or minimise double taxation or dual taxation of corporate income (see ECONOMIC DOUBLE TAXATION, FRANKED INVESTMENT INCOME).

**ERBSCHAFTSTEUER** — (German) Succession duty.

**ERGEBNISABFÜHRUNGSVERTRAG** — (German) A contract between 2 enterprises whereby one undertakes to distribute all its income to the other. Full distribution is a condition for ORGANSCHAFT (q.v.) treatment.

**ERROR, DEPARTMENTAL** — Where a taxpayer has been underassessed by departmental error, and through no fault of his own, it is usually the case that the Tax Department has the right to go back and make an assessment of the uncharged tax, even though up to 6 years (in some countries even longer) may have elapsed. In some cases, where hardship would be caused by attempting to collect the old tax there are provisions for foregoing some or all of the tax involved. Such procedures exist, for example, in Britain, although to keep matters under control the circumstances under which tax may be foregone are usually closely circumscribed.

**ERROR OR MISTAKE** — Where a taxpayer has overpaid tax because of some innocent error or mistake in his tax declaration, and the period for making an appeal gainst the assessment made on the basis declaration has expired, some countries have a special procedure to give relief. In Britain a 6-year time limit is allowed for such claims to be made. The main condition is that the error was made in the declaration by the taxpayer upon which the tax assessment was actually based.

**ESCALATION** — In tax parlance the term is used to refer to the escalation (or pyramiding) effect on prices caused by the imposition of sales taxes where the tax-inclusive price is fixed at a higher level than the old price by an amount which is greater than would be strictly justified by the precise amount of the tax embodied in the new price. It is commonly supposed, for example, that if a trader habitually marks up his prices by a certain percentage he will also apply the mark-up to the tax element in the price. In practice, where there is adequate competition between traders, fears of such escalation or pyramiding effects on prices are often exaggerated, but escalation may sometimes occur in the immediate aftermath of the imposition of a new tax. (See also RATCHET EFFECT.)

**ESTATE DUTY** — A form of death taxation applied in the U.S.A. and various other countries as a mutation tax on the total assets which pass on death. It is usual to exempt estates below a certain value and to apply graduated rates to the remainder of the estate, but without reference to the manner in which the estate may have been bequeathed to beneficiaries. The U.S.A. version, exceptionally, allows "marital relief" in repect of that part of an estate bequeathed to a surviving spouse, subject to a maximum of one half the value of the whole estate or $ 250,000 whichever is greater, and exempts bequests to charity. (See also CAPITAL TRANSFER TAX, LEGACY DUTY, SUCCESSION DUTY, and QUICK SUCCESSION RELIEF.)

**ESTATE PLANNING** — This term refers to steps taken to avoid having to pay excessive tax on one's income and capital; where the process is taken to extremes, the term may be taken to be a mere euphemism for Tax Avoidance.

**ESTATE TAX** — The federal tax levied in Canada on the estate of deceased persons which exceed C$ 50,000 in value at rates which rise to a maximum of 50 percent or the excess of the total value over C$ 300,000. Partial credit is given for PROVINCIAL SUCCESSION DUTIES (q.v.). Canadian estates of non-domiciled persons are taxed at a flat rate of 15 percent, with an exemption of C$ 5,000 (see also NOTCH PROVISION).

**ESTIMATED INCOME TAX** — The sum of tax payable on account in countries where income tax is payable on the income of the current year or where for some reason the tax cannot be calculated at the time the annual declaration of income is due.
In the U.S.A., which collects tax currently on current income, a taxpayer not adequately covered by a P.A.Y.E. scheme of tax deductions from income is required to make quarterly payments on account. A penalty for inadequate estimated payments is only due if the estimates prove to be less than 80 percent of the actual income.

**ETABLISSEMENT STABLE** — (France) Permanent establishment.

**EUROPEAN ECONOMIC COMMUNITY (E.E.C.)** — This association of West European States, amounting, inter alia, to a CUSTOMS UNION (q.v.), was set up by the Treaty of Rome and originally comprised Belgium, France, Federal Germany, Holland, Italy, and Luxembourg, and now includes Britain, Denmark, and Eire as well as some associated states. The group is also known as the E.E.C., the European Communities, and "the Nine". Membership entails having a common external tariff pursuing a COMMON AGRICULTURAL POLICY (q.v.), harmonisation of the tax system, e.g., by adopting VALUE ADDED TAX (q.v.).

**EVASION** — The term applied to the avoidance of tax by unlawful means including the omission of taxable income or transactions from tax declarations, or the reduction of the amount properly due by fraudulent misstatement or misrepresentation.

**EXCEPTIONAL USE OF PLANT AND MACHINERY, ETC.** — Where it is usual for plant and machinery to be used on single-shift working, and particular firms use their machines intensively e.g., on double- or treble-shift working, it is usual to grant higher than normal rates of depreciation for tax purposes. This may be done either under some specific statutory provision, or by agreeing on some ad hoc rate of allowance, higher than normal, for the period of the exceptional working

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

**EXCESS PROFITS DUTY (E.P.D.)** — The duty levied in Britain from the commencement (on 4 August 1914) of World War I on the excess of business profits above traders' "standard" profits, as an attempt to take at least some of the profit out of war. The levy applied to profits made in the period up to 30 June 1921 commenced at 50 percent and eventually rose to 80 percent. The standard profits were computed as the average profits of any two of the three pre-war years. As relief was given for losses or deficiencies of profits a good deal of the tax yield was eroded by relief given for such deficiencies in the slump period which followed the war, a situation caused partly because of the continuance of the tax for nearly three years after the end of the war in 1918.

**EXCESS PROFITS LEVY (E.P.L.)** — The Excess Profits Levy in Britain was in force from 1 January 1952 to 31 December 1953 and was charged at 30 percent on the amount by which the profits of a corporate body exceeded its standard profits, subject to a ceiling of 15 percent of total profits. The standard profits were computed as the average of any two of the three years 1947, 1948 and 1949 with a minimum of £5,000 and certain alternatives based on the amount of capital employed in the chargeable periods.

**EXCESS PROFITS TAX (E.P.T.)**—The Excess Profits Tax in Britain was in force from 1 April 1939 to 31 December 1946, i.e., for a period from 5 months before World War II to a date roughly 21 months after the end of that war. The rates charged were 60 percent for the 12 months to 31 March 1940, 100 percent for the period 1 April 1940 to 31 December 1945, and 60 percent for the final 12 months to 31 December 1946. Of the 100 percent tax, 20 percent was refundable as a POST WAR REFUND (q.v.). The tax was chargeable where profits exceeded a standard profit based on pre-war profits of the taxpayer with certain adjustments for new capital employed in the business and with an alternative basis where the pre-war profit standard was inapplicable. Where the amount chargeable as excess profits tax was less than the amount chargeable as PROFITS TAX (q.v.) the latter tax superseded the former. In calculating the taxable profits, a deduction was made for repairs which had to be deferred to a later year because of wartime restrictions and scarcities. (See DEFERRED REPAIRS.)

**EXCESS RENTS** — Under the British income tax system, income from property was formerly chargeable under Schedule A in accordance with the annual value of the property, properties being re-valued quinquennially in accordance with the rents prevailing and other relevant criteria. When the re-valuation process fell into arrear because of preoccupation with war, properties which were rented at figures higher than the annual value were subjected to tax (under Schedule D) on the excess of the rent, which tax was payable in addition to the Schedule A tax. With the partial abolition of Schedule A, income from property is now charged on the rent received, less expenses. (See also SCHEDULE A and SCHEDULE D.)

**EXCISE DUTIES** — Excise duties are revenue duties imposed normally on goods manufactured within a country, usually as a specific levy per unit of weight or volume. Where corresponding goods are also imported, the customs duty on the imports usually coincides with the excise duty, but there may also be a PROTECTIVE DUTY (q.v.) in addition. Excise duties are classically charged on products such as liquor, tobacco and motor fuels and usually a comparatively small number of manufactured products.

**EXCISE TAXES** — Excise taxes are similar to excise duties except that the tax is levied ad valorem instead of on a specific basis and sometimes the term is used to refer to a tax which might equally be called a MANUFACTURER'S or WHOLESALE TAX (q.v.). Hence an excise tax may be levied on imports as well as local products. There is no inviolable rule about the respective use of the terms "excise taxes" and "excise duties", but they are most commonly used in the sense indicated.

**EXCLUSION** — The term used in connection with single-stage sales taxation, denoting that although a product is not charged with tax in the course of transaction by a particular trader and is thus "excluded" from the computation of sales tax payable by him, there is no actual "exemption". The commodity thus excluded from tax at one stage of distribution would, in fact, be taxed at an earlier stage under a FORFAITAIRE system (q.v.) or because the trader has opted not to be registered for sales tax and thus buys his supplies pre-taxed from a registered trader who pays the sales tax on his sales to the un-registered trader. (See also FORFAITAIRE, re goods excluded from some stages of taxation under a CASCADE system.)

**EXEMPTION** — This term has two meanings; an item of income or a commodity or service may be freed altogether from income tax or indirect taxes and this process is known as the "exemption" of the item from tax. The word is also used to refer to reliefs or allowances in U.S. terminology, for example, an individual is entitled to a basic "exemption" of $ 750 in computing his income tax and a further exemption of $ 750 for each qualifying dependent. These sums are deducted from his income before computing income tax on the balance.

**EXEMPT SECURITIES** — On the basis that gilt-edged (Govt.) securities are usually issued at or near par and eventually redeemed at par so that fluctuations in the price of the stock, causing losses to some holders and gains to others, produce no net tax base for capital gains tax, such securities have been excluded from capital gains tax in Britain. The exclusion does not apply to all gilts, those within the exclusion are listed in the law. Moreover, the exemption of gains (and non-recognition of losses) does not apply where the securities are held for less than 12 months, or are held by those who deal in securities.

**EXERCICE** — (France and Belgium) Financial Year.

**EXIT TAX** — This term is usually synonomous with the service charge made for the use of the passenger facilities at an airport ("AIRPORT TAX", q.v.) or, less usually, for port facilities.

**EXPENDITURE TAX** — The term is usually used to refer to a graduated tax on expenditure by the taxpayer. Such a tax was advocated by Dr. Irving Fisher in 1937 and subsequently by Dr. Kaldor and was adopted by India and Sri Lanka following Dr. Kaldor's recommendations to those governments. Both India and Ceylon subsequently abandoned this form of taxation. Briefly, the concept is that it is more appropriate to tax a consumer's expenditure than his income in that the former type of tax will restrict wasteful expenditure and encourage saving, while the latter will discourage personal exertion to earn income. Introduction of an expenditure tax would, in theory, enable income taxes on the higher income brackets to be eliminated, thus removing a dis-incentive to productivity, but administrative difficulties are daunting even if the theory is accepted. The idea of such tax has again been mooted (January 1978) by the Meade Committee in Britain.

**EXPENSE ACCOUNT** — The term is used to refer to the facility granted to certain directors and employees which usually permits them to incur "business" expenditure up to a certain limit in performing their duties. The danger that such accounts may become a fringe benefit has been tackled in various countries (see also ENTERTAINMENT EXPENSES), but the main administrative problem is to try to prevent abuse for tax purposes without discouraging too much the efforts of salesmen and others to promote business, and particularly export business.

**EXPENSE RATIO** — The term is usually applied to the ratio of the cost of collecting a tax to the yield from it (see COLLECTION COSTS). Nowadays increasing attention is being directed to the cost to the private sector of "administering" a tax as well as the cost on the government side.

**EXPENSES** — Expenses incurred in producing income are normally allowed as a deduction for income tax purposes when assessing that income (see also ENTERTAINMENT EXPENSES, EXPENSE ACCOUNT). A distinction has been drawn in British Income Tax law between expenses wholly, exclusively, and necessarily incurred in producing the income, which are deductible in respect of employments, and expenses which are wholly and exclusively incurred in producing the income which are deductible in computing the profits of a business or profession. The more restrictive test for employments may be partly justified by the fact that an employee must carry out his duties in the manner in which his employer desires him to and that by common law an employer is supposed to provide the necessary tools and materials to enable an employee to carry on his employment.

**EXPENSING OF ROYALTIES** — Agreements between a government and an entrepreneur in the private sector with regard to the exploit of minerals and occasionally of other natural resources are often incorporated in a special agreement which supersedes the application of the ordinary taxing laws. At one time, it was common for such an agreement to provide for a certain total yield of royalties and income tax, e.g., on a 50/50 basis, such that the royalty was regarded as a payment on account of income tax on the total profits exclusive of royalties which would have a ceiling of 50 percent of those profits. The current tendency is, however, for income tax to be charged at a rate which now frequently exceeds 50 percent of the profits of mineral operations, after deducting royalty payments, no account being taken of the amount of royalty paid in computing the income tax bill except to the extent that royalties paid reduce the profits chargeable to income tax. The latter treatment whereby the royalties are merely regarded as a business expense is known as "expensing" the royalties.

**EXPLORATION EXPENDITURE** — Although governments do not usually subsidise the emmense costs of exploration for oil and other minerals, it is usual to deal fairly generously with such expenditure for tax purposes. If the exploration is successful the expenditure may normally be written off as part of the cost of setting up the mine, well, etc. Where unsuccessful, there may be allowances for the abortive expense. (See ABORTIVE PROSPECTING.)

**EXPORT BONUS** — Incentives to export are not generally admissible under the terms of G.A.T.T. Some countries have operated a system of granting import certificates to encourage exporting firms, particularly where imports have been severely restricted such that the right to import scarce goods confers a more or less guaranteed right to make profits from the goods imported.

**EXPORT DUTY** — Export duties are commonly levied on exports of plantation or agricultural produce, particularly the basic commodities entering into world trade, such as rubber, copra, palm oil, sisal, tea, cocoa and coffee. Such duties are usually fairly cheap to collect, being levied in bulk on outgoing cargoes and may be productive where the exporting country has some natural advantage of climate, soil, etc., in producing the particular commodity. In some cases export duties have been levied on mineral exports, although in this case royalties and special taxation agreements with the mineral producers are tending to supersede export duties.

**EXPORT PROCESSING ZONE** — Certain countries have established tax-free enclaves into which raw materials may be brought, processed and exported without tax being levied either on the products or, sometimes, on the profits from the operations carried out. The income tax exemption is usually limited in time and where no income tax concession is involved the tax-free facilities are little different, in essence, from those given by countries with large international ports in providing within the vicinity of a port or airport an area in which customs duties do not apply because the area is regarded as outside the central customs area.

**EXPORT REBATE** — Where goods which are to be exported have been subjected to indirect taxation in the exporting country either directly or because tax is embodied in some of the constituents or components it is normal to rebate or refund such tax when the goods are exported. It is not always easy to identify or quantify the tax involved and sometimes the rebate is calculated with the help of various approximations. An example of such a rebate was the export rebate provided in Britain which covered certain elements such as vehicle, and vehicle fuel, taxation and which was reduced to two or three flat percentage rates of rebate in respect of various categories of exported goods, but withdrawn after protests from certain importing countries. One of the main advantages of V.A.T. (q.v.) is that the exporter is enabled to quantify the tax embodied in his export quite simply and can obtain a credit or refund therefor.

**EXPORT TAX** — See EXPORT DUTY.

**EXTERIOR SIGNS OF WEALTH, EXTERNAL EVIDENCE OF MEANS, EXTERNAL INDICIA OF WEALTH** — These three expressions have approximately the same meaning, and in some countries (France, Spain) evidence of style of living has been used systematically to arrive at minimum income tax liability where the taxpayer declares lower income than is compatible with his evident standard of living. Apart from that most countries when investigating the accuracy of income or profits declarations, take account of the taxpayer's likely cost of living. In France a new tax has recently (1977) been introduced as a kind of levy on wealth (in addition to income tax) represented by 11 factors indicative of "wealth". A person with more than 3 of the 11 factors is within the scope of the tax, and the items include private aeroplanes, racehorses, yachts, cars with engine capacity exceeding 3 litres, employment of a maid, having golf or shooting as a hobby. The tax is charged at 2 percent on values derived from these elements plus 3 times the annual value of a second residence if one is maintained as a holiday home. (See also MORTON'S FORK.)

[ to be continued ]

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# Contents

of the April 1978 issue



**In next issues:**

Legal regulation of taxes, levies and fees in the Czechoslovak Socialist Republic
— by *Dr. Milan Bakes*

The German corporation tax reform and the revision of double tax treaties
— by *Dr. Theodor Faist*

The future of personal income taxation
— by *Dr. Barry Bracewell-Milnes*

India: Capital Gains Tax
— by *Kailash C. Khanna*

The evolution of Mexico's public revenue structure, 1877-1977
— by *Arthur J. Mann*

The definition of statutory net income in schedular and global income tax systems
— by *Sylvain R.F. Plasschaert*

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

# ASEAN: Recent Development in Trade Preferences and Comprehensive Double Taxation Agreements

by Jap Kim Siong

CONTENTS



## I. TRADE PREFERENCE SCHEMES AMONG DEVELOPING ASIAN COUNTRIES

### A. Introduction

The very vital role that international trade among developing countries plays in economic development is fully recognized by the international community. To promote trade among developing countries the international community recognize the importance of encouraging the establishment of trade preferences among developing countries at the international, regional and sub-regional levels. This has been illustrated through (a) three United Nations documents, i.e. (i) the Resolution of the General Assembly of the United Nations establishing the International Development Strategy for the Second United Nations Development Decade, (ii) the Declaration on the Establishment of a New International Economic Order and (iii) the Programme of Action for the Establishment of a New International Economic Order, (b) the concerted Declaration on Trade Expansion, Economic Cooperation and Regional Integration among Developing Countries adopted by the Second United Nations conference on Trade and Development (UNCTAD II), as well as (c) Part IV of the General Agreement on Tariff and Trade (GATT). [1]

The oldest scheme of trade preference among developing countries at regional level is the Latin American Free Trade Association (LAFTA) established in 1960 by the Montevideo Treaty. [2]

At the sub-regional level there are the Central American Common Market (CACM), the Andean Common Market (Ancom) and the Caribbean Community (CARICOM). [3]

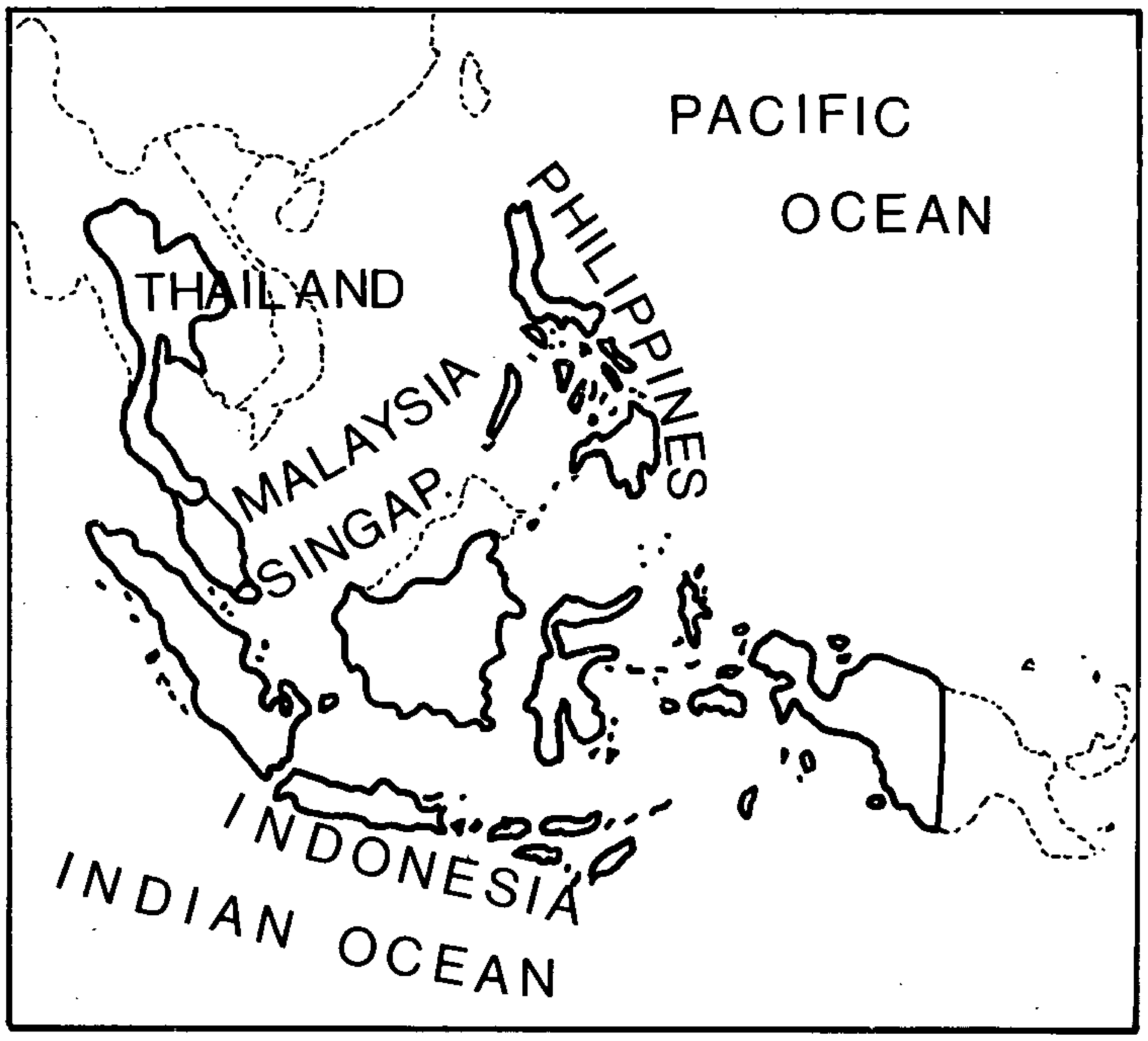
In Africa the main sub-regional trade preference arrangements are the Central African Customs and Economic Union or Union Douanière et Economique de l'Afrique Centrale (UDEAC in French) and the Economic Community of West African States (ECOWAS) (CEAO in French). [4]

In Asia, the venue for negotiations for multilateral trade preference arrangements on a regional basis to liberalize trade among participating countries has been initiated by the United Nations and Social Commission for Asia and the Pacific otherwise also known as ESCAP. [5]

With the support of ESCAP, seven member countries — Bangladesh, India, Laos, the Philippines, Republic of Korea, Sri Lanka and Thailand — began negotiations that culminated in the signing in Bangkok on July 13, 1975 of the First Agreement on Trade Negotiations among Developing Member countries of the Economic and Social Commission for Asia and the Pacific (ESCAP) also called the Bangkok Agreement.

The basic objective of the Bangkok Agreement is the establishment of trade preferences among the ESCAP countries, complementary to other efforts undertaken in other international institutions in order to contribute to trade and development in accordance with Part IV of GATT on the regional level

1. See *Kenneth W. Dam*. The GATT Law & International Economic Organization. The University of Chicago 1970. Appendix: Text of General Agreement.
2. See IMF Survey, Special Issue on Trade July 4, 1977.
3. See Recent Development in Taxation in Latin America and the Caribbean by *Mr. A. Atchabahian*. Bulletin for International Fiscal Documentation, Amsterdam 1977/7 at page 301.
4. See *African Tax Systems* Part: Fiscal Cooperation — Section D, International Bureau of Fiscal Documentation, Amsterdam.
5. The ESCAP region officially comprises the countries of Afghanistan, Australia, Bangladesh, Bhutan, Brunei, Burma,




of ESCAP countries. Of the ASEAN member countries, [6] Indonesia, Malaysia, the Philippines and Thailand participated in the original negotiations for the Bangkok Agreement. Yet only the Philippines and Thailand signed the Bangkok Agreement. Singapore was excluded from the negotiations because it was no longer considered a developing country under the Bangkok scheme. The ASEAN member countries seemed apparently unwilling to throw full support behind the Bangkok Agreement probably because of their uncertainty about the role any future trade liberalization efforts by ASEAN member countries might play within the larger Bangkok scheme.

In addition, to the Bangkok Agreement, in Asia, there are two (one effective) sub-regional arrangements for integration with trading aspects initiated by the Association of South East Asian Nations (ASEAN) comprising Indonesia, Malaysia, the Philippines, Singapore and Thailand and by the Regional Cooperation for Development (RCD) comprising Iran, Pakistan and Turkey.

The Bangkok Agreement was followed by the Manila Agreement signed on February 24, 1977 (the Agreement on ASEAN Preferential Trading Arrangements (PTA) by member countries of ASEAN).

The other sub-regional trade preference scheme is processed under the Treaty of Izmir signed on March 12, 1977 in Tehran by the Foreign Ministers of the Regional Cooperation for Development comprising Iran, Pakistan and Turkey. [7]

The RCD Protocol on Trade envisaging tariff preference among the member countries of RCD, viz., Iran, Pakistan and Turkey, is still under negotiation and has not been concluded.

The aim of this article is to focus the development towards the Agreement on ASEAN Preferential Trading Arrangements (PTA) only.

## B. What is ASEAN?

In South East Asia regional economic cooperation started with the formation of the Association of South-east Asia (ASA) by the Federation of Malaya, Thailand and the Philippines on July 31, 1961. ASA had among its aims:

1) to establish the means for friendly consultations, collaborations and mutual assistance in the economic, social, cultural, scientific and administrative fields, and
2) cooperation in the study of problems of international commodity trade.

On August 8, 1967, the need to widen regional cooperation resulted in the signing of the Joint Declaration in Bangkok — also referred to as the Bangkok Declaration — by the 3 original ASA member countries, Indonesia and Singapore. [8] This Declaration established the Association of Southeast Asian Nations (ASEAN).

Singapore being independent of the Federation of Malaya then as an independent state signed the Bangkok Declaration. The aims, purposes and mechanics for consultation of the ASA were adopted by the ASEAN but with emphasis on socio-economic and technical cooperation.

The ASEAN aims at specific and effective collaboration between its member countries for the greater utilization of their agricultural and industrial resources, the expansion of their trade, and the study of the problems of international commodity trade.

The First Summit Meeting between ASEAN heads of government which took place in Den Pasar, Bali, Indonesia, on February 23 and 24, 1976 resulted in the signing of (i) the Treaty of Amity and Cooperation in South East Asia [9] and (ii) of the Declaration of ASEAN Concord. [10] This was the first positive step taken. Between 1967-76 nothing concrete had resulted from this alliance. Only official statements of intent for the promotion of economic regional cooperation had been published. These, however, had not been acted upon.

The purpose of the treaty, as its name implies, is to promote perpetual peace, everlasting amity and cooperation among ASEAN peoples. This would it is said, contribute to solidarity, a closer effective cooperation and unity among these peoples.

The Concord provides for the agreement to develop five ASEAN industrial projects and to achieve preferential

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China, the Cook Islands, Democratic Kampuche (Cambodia), Fiji, the Gilbert Islands, Hong Kong, India, Indonesia, Iran, Japan, Democratic People's Republic of Korea, Republic of Korea, Lao People's Democratic Republic, Malaysia, Mongolia, Nauru, Nepal, New Zealand, the Pacific Islands, Pakistan, Papua New Guinea, the Philippines, Samoa, Singapore, Socialist Republic of Viet Nam, the Solomon Islands, Sri Lanka, Thailand and Tonga.

6. See for a discussion next paragraph and section 2 of this article.
7. Reginal Cooperation for Development (RCD) thirteenth anniversary, Tehran, July 21, 1977 at page 9.
8. See Appendix I for the text of the Declaration.
9. Not reproduced in this article.
10. See Appendix II.

trading arrangements in the ASEAN member countries designed to provide a framework for the expansion of intra-Asean trade.

It is generally admitted that after the 1976 Declaration of ASEAN Concord, all five member countries have taken regional economic cooperation more seriously and have achieved more in two years than in the previous decade of ASEAN existence since its establishment in 1967 by the Bangkok Declaration, so that one could even regard the 1976 agreements as a NEW ASEAN.

1. *Joint industrial investment projects*

The most important result is the agreement to cooperate on five large scale industrial investment projects, but also further cooperation is envisaged in many other fields, such as the multilateral tariff preference scheme embodied in the Agreement on ASEAN Preferential Trading Arrangements.

During their Second Meeting held in Kuala Lumpur on March 8 and 9, 1976, the following ASEAN industrial large scale projects were agreed by the ASEAN Economic and Planning Ministers:

| | | |
|---|---|---|
| Indonesia: | — | urea |
| Malaysia: | — | urea |
| Philippines: | — | superphosphates |
| Singapore: | — | diesel engines |
| Thailand: | — | soda ash |

The host country, in general, will provide 60 percent of the equity capital of the industrial project and the other four ASEAN countries 10 percent each.

The establishment of ASEAN industrial projects may result in trade diversion and may also serve to meet the countries' desire for industrialization while vesting them with greater interest in the preservation of regional trade preference arrangements. To make the ASEAN industrial projects economically viable the products must be eligible for trade preferences within ASEAN.

This may be achieved by simultaneous tariff concessions and economic regional cooperation which would result in the long term in a successful balanced production structure among ASEAN countries so that a substantial volume of intra-regional trade would eventually be achieved.

2. *The Agreement on ASEAN Preferential Trading Arrangements (PTA)*

The ASEAN member countries agreed in the Declaration of ASEAN Concord to progress towards the establishment of preferential trading arrangements subject to the unanimous agreement of the member countries.

No definite date was agreed by which the trading arrangements must be finalized. The only indicator of time in the ASEAN Concord is the statement that the agreement to establish trading arrangements must be regarded *as a long term objective on a basis deemed to be at any particular time appropriate through rounds of negotiations.* However, the five ASEAN countries have signed already in Manila (on February 24, 1977) the Agreement on ASEAN Preferential Trading Arrangements (PTA). [11]

The basic preferential trading arrangements in the Agreement cover:
- tariff reductions to be applied on a product-by-product basis to all ASEAN countries on a most-favoured-nation basis;
- liberalization of non-tariff barriers on a preferential basis;
- long-term commodity supply contracts of up to five years;
- trade financing at preferential interest rates.

The review and supervision of the implementation of the Agreement on ASEAN Preferential Trading Arrangements (PTA), is entrusted to the ASEAN Committee on Trade and Tourism (referred to as COTT).

To qualify under the PTA, goods eligible for preferences must in general be consigned directly to the importing member country and must comply with the origin criteria specified in the Agreement on ASEAN PTA. Goods wholly produced in an ASEAN country are considered as originating in that country. Products only partly produced or obtained within the exporting ASEAN country will also qualify for preferential concessions if at least 50 percent of the F.O.B. value of the product is added in that country, with the exception of Indonesia where it is 40 percent. A product will also be eligible for preferential treatment if the aggregate ASEAN content of a final product totals not less than 60 percent of its F.O.B. value.

According to the Rules of Origin of the ASEAN PTA the following are to be considered as wholly produced or obtained in the exporting ASEAN country:
(a) mineral products extracted from its soil, its water or its seabeds;
(b) agricultural products harvested there;
(c) animals born and raised there;
(d) products obtained from animals referred to in paragraph (c) above;
(e) products obtained by hunting or fishing conducted there;
(f) products of sea fishing and other marine products taken from the sea by its vessels;
(g) products processed and/or made on board its factory ships exclusively from products referred to in paragraph (f) above;
(h) used articles collected there fit only for the recovery of raw materials;
(i) waste and scrap resulting from manufacturing operations conducted there;
(j) goods produced there exclusively from the products referred to in paragraph (a) to (i) above.

The Agreement on ASEAN Preferential Trading Arrangements was ratified by all ASEAN member countries in the same year as it was signed. In addition the first trade preferences agree on a total of 71 items covering both primary and manufactured goods has been approved by the ASEAN Economic Ministers and were im-

11. See Appendix III.

plemented by the individual ASEAN countries to enter into force as of January 1, 1978. Details of the first schedule of tariff reductions on the 71 commodities for ASEAN preferential trading arrangements are reproduced in Appendix IV.

Additional preferences have also been agreed for 507 items during the last meeting of the Committee on Trade and Tourism and the Trade Preferences Negotiating Group. These items should be approved by the ASEAN Economic Ministers at their meeting in Jakarta to be held early in 1978 after which the preferences will enter into force.

It is apparent from the first trade preferences that the size of the concessions granted average mostly 10 percent. This is only nominal and would seem to make no real contribution to increase the volume of intra-ASEAN trade in practice. However, as ASEAN officials responsible for trade preference negotiations have pointed out the long-term objectives of the negotiations are initially to break down psychological barriers and allow ASEAN member countries to grow used to the idea of granting each other trade preferences. As the idea of preferential trade is accepted and the number of products covered increases protectionist sentiments will wane, and the concessions may increase.

## C. Why ASEAN?

The volume of intra-ASEAN trade is very small. The main trade links are not between each of the member countries but with industrialized companies of Japan, the U.S.A. and West Europe. Intra-ASEAN trade constitutes only about 16 percent of the total trade.[12] This has increased since 1967 when intra-ASEAN trade was only 9.5 percent of the total trade.[13]

As trade among ASEAN countries constitutes a small fraction of their total trade it seems obvious first to increase the volume of trade between them before negotiating trade preferences. With a low level of trade there is no need to have tariff reductions for intra-ASEAN trade.

Leaving Singapore as an industrialized state aside, the economies of the other four ASEAN member countries are not complementary in trade. They are competitive. All are exporters of primary commodities consisting of tropical agricultural and forestry products like rubber, tin, timber, rice, sugar, palm oil plus oil in the case of Indonesia and Malaysia. Consequently their similar economic structures hamper the increase in the volume of trade because of the absence of a substantial diversity of trade possibilities. In other words, the production structure of ASEAN countries — and in general all developing countries — tends to be competitive with one another, while the production structure of developed and developing countries tends to be complementary.

12. ASEAN: A New Era of Understanding and Cooperation. *Asia Research Bulletin* Singapore, Part 6, March 31, 1976.
13. Southeast Asia's economy in the 1970's. Asian Development Bank, Longman, London 1971 at page 98.

**TABLE I: INDONESIA**

**Imports by country of origin (millions of U.S. $)**

| Country | 1974/1975 | 1975/1976 | 1976/1977 |
|---|---|---|---|
| **Europe** | | | |
| Netherlands | 105 | 138 | 165 |
| Belgium and Luxemburg | 44 | 63 | 71 |
| Czechoslovakia | 2 | 12 | 4 |
| United Kingdom | 167 | 146 | 169 |
| Italy | 55 | 80 | 59 |
| German Federal Republic | 359 | 365 | 460 |
| German Democratic Republic | 1 | — | 2 |
| France | 86 | 85 | 194 |
| Spain | 2 | 2 | 3 |
| Sweden | 16 | 15 | 21 |
| Switzerland | 33 | 40 | 34 |
| Other | 153 | 191 | 53 |
| Total import from Europe | 1,023 | 1,137 | 1,235 |
| Percentage of total imports | 23.1% | 24.4% | 24.1% |
| **America** | | | |
| Canada | 45 | 62 | 60 |
| United States of America | 637 | 704 | 877 |
| Other | 19 | 23 | 23 |
| Total import from America | 701 | 789 | 960 |
| Percentage of total imports | 15.8% | 16.9% | 18.7% |
| **Africa** | | | |
| United Arab Republic | — | — | — |
| East African Community | 20 | 101 | 48 |
| South Africa | — | — | — |
| Other | 14 | — | — |
| Total import from Africa | 34 | 101 | 48 |
| Percentage of total imports | 0.7% | 2.1% | 0.9% |
| **Asia** | | | |
| Burma | 21 | 31 | 85 |
| Hongkong | 122 | 51 | 62 |
| India | 25 | 79 | 76 |
| Japan | 1,325 | 1,422 | 1,139 |
| Pakistan | 54 | 12 | 23 |
| Philippines | 12 | 15 | 14 |
| Malaysia | 16 | 19 | 17 |
| Thailand | 86 | 33 | 198 |
| China | 186 | 169 | 84 |
| Singapore | 228 | 356 | 497 |
| Other | 380 | 278 | 498 |
| Total import from Asia | 2,515 | 2,465 | 2,693 |
| Percentage of total imports | 56.7% | 52.9% | 52.5% |
| **Australasia** | | | |
| Australia | 149 | 104 | 173 |
| New Zealand and Oceania | 15 | 67 | 19 |
| Total import from Australasia | 164 | 171 | 192 |
| Percentage of total imports | 3.7% | 3.7% | 3.8% |
| Total import of Indonesia | 4,437 | 4,663 | 5,128 |

*Source:* Central Bureau of Statistics. Reprinted from BANK INDONESIA. Report for the Financial Year 1976/1977 (slightly revised).

**TABLE II: INDONESIA**

**Exports by country of destination (millions of U.S. $)**

| Country | 1974/1975 | 1975/1976 | 1976/1977 |
|---|---|---|---|
| **Europe** | | | |
| Netherlands | 166 | 158 | 272 |
| Belgium and Luxemburg | 11 | 12 | 16 |
| Denmark | 8 | 9 | 31 |
| United Kingdom | 23 | 36 | 54 |
| Italy | 16 | 33 | 81 |
| German Federal Republic | 171 | 131 | 209 |
| Norway | 2 | 2 | 5 |
| France | 18 | 15 | 36 |
| Sweden | 4 | 2 | 3 |
| Other | 58 | 54 | 88 |
| Total export to Europe | 477 | 452 | 795 |
| Percentage of total exports | 6.4% | 6.4% | 8.5% |
| **America** | | | |
| United States of America | 1,546 | 1,969 | 2,728 |
| Canada | 33 | 10 | 18 |
| Other | 461 | 643 | 596 |
| Total export to America | 2,040 | 2,622 | 3,342 |
| Percentage of total exports | 27.3% | 36.9% | 35.7% |
| **Africa** | | | |
| Egypt | — | 1 | 4 |
| Mozambique | — | — | — |
| South Africa | — | — | — |
| Other | 20 | 3 | 16 |
| Total export to Africa | 20 | 4 | 20 |
| Percentage of total exports | 0.3% | 0.1% | 0.2% |
| **Asia** | | | |
| Burma | 15 | 3 | — |
| Hong Kong | 25 | 27 | 26 |
| India | 5 | 8 | 9 |
| Iraq | — | 14 | 16 |
| Japan | 3,940 | 3,008 | 3,854 |
| Malaysia | 82 | 56 | 17 |
| Thailand | 7 | 3 | 1 |
| Pakistan | 44 | 33 | 35 |
| Philippines | 4 | 33 | 128 |
| Singapore | 555 | 609 | 729 |
| Other | 187 | 202 | 362 |
| Total export to Asia | 4,864 | 3,996 | 5,177 |
| Percentage of total exports | 65.3% | 56.3% | 55.2% |
| **Australasia** | | | |
| Australia | 24 | 24 | 30 |
| New Zealand | 1 | 1 | 3 |
| Oceania — Hawaii | 30 | — | — |
| Total export to Australasia | 55 | 25 | 33 |
| Percentage total of exports | 0.7% | 0.3% | 0.4% |
| Others[1)] | 2 | 3 | 4 |
| Total export of Indonesia | 7,458 | 7,102 | 9,371 |

1) Including exports via free port.

*Source:* Central Bureau of Statistics. Reprinted from BANK INDONESIA. Report for the Financial Year 1976/1977 (slightly revised).

**TABLE III: THAILAND**

**Exports by country of destination and imports by country of origin (Percent of total)**

| | Exports | | | Imports | | |
|---|---|---|---|---|---|---|
| | 1960 | 1970 | 1976 | 1960 | 1970 | 1976 |
| Japan | 18 | 26 | 26 | 26 | 37 | 32 |
| United States | 14 | 13 | 10 | 17 | 15 | 13 |
| West Germany | 5 | 4 | 3 | 8 | 8 | 5 |
| United Kingdom | 4 | 2 | 2 | 10 | 7 | 4 |
| Malaysia | 17 | 6 | 4 | 2 | 1 | 1 |
| Hong Kong | 9 | 8 | 5 | 6 | 1 | 1 |
| Singapore | 11 | 7 | 7 | 7 | 1 | 3 |
| Netherlands | 2 | 9 | 13 | 5 | 1 | 1 |
| Taiwan | 1 | 5 | 3 | 1 | 2 | 2 |
| Indonesia | 4 | 2 | 5 | 3 | 1 | — |
| Italy | — | 2 | 1 | 1 | 2 | 1 |
| Saudi Arabia | 2 | 2 | 2 | — | 2 | 8 |
| India | — | 1 | — | 1 | 1 | 1 |
| Australia | — | 1 | 1 | 1 | 3 | 2 |
| Other | 13 | 12 | 18 | 12 | 18 | 26 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 |

*Source:* Bank of Thailand.
Reprinted from Bangkok Monthly Review, December 1977.

In 1974 for example, developing countries imported over twice as much from developed countries as from developing countries, and they exported almost four times as much to developed countries as to developing countries.[14]

Where similar economic situations exist economic cooperation in preference to tariff concessions is the more advisable method in the search for possible solutions to seemingly intractable problems of economic developments.

It is, however, difficult and even well-nigh impossible to find a mutually acceptable basis in such a situation for cooperation. The reason for this is that either the economies are so similar in structure and level of development (e.g. Thailand, Malaysia and the Philippines) that they compete over the same things and so fail to complement each other, or else they are so far different re development levels (like Singapore and Indonesia) that the economically weaker countries fear domination by the stronger ones.[15]

There is always, however, the chance that a well balanced and fairly distributed industrial structure in the ASEAN countries supplemented with internal trade concessions

14. See *Mark Allen.* Developing Nations Cooperate to Foster More Mutual Trade and Closer Economic Regulations. IMF Survey, Special Issue on Trade. July 4, 1977 at page 211.
15. See Economic Problems and Prospects in ASEAN countries. Edited by *Saw Swee Hock* and *Lee Soo Ann,* Singapore University Press 1977.

may prove successful in expanding the market and may lead to successful industrial development and regional integration.

The recent development in ASEAN cooperation in many fields after the long period of inaction has brought the ASEAN countries closer to one another. It took ten years of cautious association to encourage them to seek out and emphasise their similarities rather than their differences so stressing unity rather than division.

## II. INTRA-ASEAN COMPREHENSIVE DOUBLE TAXATION AGREEMENTS

In the final statement delivered after the Second Summit Meeting between the ASEAN heads of government held in Kuala Lumpur on August 4 and 5, 1977 [16] the following matters in the field of taxation were agreed:

(a) Examination of the problems of the simplification of customs procedures and formalities, harmonization of the system and methods of statistical compilation among ASEAN countries; [17]

(b) The need to extend bilateral agreement on investment guarantees and avoidance of double taxation on income among the ASEAN countries for purposes of encouraging trade, investment and business.

In this connection the following effective intra-ASEAN comprehensive double taxation treaties exist or are being negotiated;

Singapore and Malaysia signed December 26, 1968 as amended by Supplementary agreement of July 6, 1973.

Singapore and Thailand signed September 15, 1975.

Singapore and the Philippines signed August 1, 1977.

The Minister of Finance of Singapore has admitted that Singapore currently is granting income tax exemption in certain cases for Singapore investors in Indonesia despite the fact that there is no effective comprehensive double taxation treaty between the two countries. Negotiations for the conclusion of a comprehensive double taxation treaty between the two countries have not yet been fertilized.

Malaysia is negotiating with Thailand a comprehensive double taxation treaty with respect to taxes on income. The Philippines is contemplating negotiating for comprehensive double taxation treaties with Indonesia and Thailand.

16. See Far Eastern Economic Review, August 19, 1977 issue. Hong Kong.

17. At present comparison of statistics of ASEAN countries is quite a nightmare. For illustration see appended STATISTICS in this article.

# APPENDIX I

# 1967 ASEAN Declaration

The Presidium Minister for Political Affairs/ Minister for Foreign Affairs of Indonesia, the Deputy Prime Minister of Malaysia, the Secretary of Foreign Affairs of the Philippines, the Minister for Foreign Affairs of Singapore and the Minister of Foreign Affairs of Thailand

MINDFUL of the existence of mutual interests and common problems among the countries of South East Asia and convinced of the need to strengthen further the existing bonds of regional solidarity and cooperation;

DESIRING to establish a firm foundation for common action to promote regional cooperation in South East Asia in the spirit of equality and partnership and thereby contribute towards peace, progress and prosperity in the region;

CONSCIOUS that in an increasingly interdependent world, the cherished ideals of peace, freedom, social justice and economic well-being are best attained by fostering good understanding, good neighbourliness and meaningful cooperation among the countries of the region already bound together by ties of history and culture;

CONSIDERING that the countries of South East Asia share a primary responsibility for strengthening the economic and social stability of the region and ensuring their peacesul and progressive national development, and that they are determined to ensure their stability and security from external interference in any form or manifestation in order to preserve their national identities in accordance with the basic ideals and aspirations of their peoples;

AFFIRMING that all foreign bases are temporary and remain only with the expressed concurrence of the countries concerned and are not intended to be used directly or indirectly to subvert the national independence and freedom of States in the area or prejudice the orderly processes of their national development;

**DO HEREBY DECLARE:**

FIRST the establishment of an Association for Regional Cooperation among the countries of South East Asia to be known as the Association of South East Asian Nations (ASEAN).

SECOND, that the aims and purposes of the Association shall be:

1. To accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of South East Asian nations;

2. To promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter;

3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields;

4. To provide assistance to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres;

5. To collaborate more effectively for the greater utilization of their agriculture and industries, the expansion of their trade, including the study of the problems of international commodity trade, the improvement of their transportation and communication facilities and the raising of the living standards of their peoples;

6. To promote South East Asian studies;

7. To maintain close and beneficial cooperation with existing international and regional organizations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.

THIRD, that, to carry out these aims and purposes, the following machinery shall be established:

(a) Annual Meeting of Foreign Ministers, which shall be by rotation and referred to as ASEAN Ministerial Meeting. Special Meetings of Foreign Ministers may be convened as required.

(b) A Standing Committee, under the chairmanship of the Foreign Minister of the host country or his representative and having as its members the accredited Ambassadors of the other member countries, to carry on the work of the Association in between Meetings of Foreign Ministers.

(c) Ad Hoc Committees and Permanent Committees of specialists and officials on specific subjects.

(d) A National Secretariat in each member country to carry out the work of the Association on behalf of that country and to service the Annual or Special Meetings of Foreign Ministers, the Standing Committee and such other committees as may hereafter be established.

FOURTH, that the Association is open for participation to all States in the South-East Asian Region subscribing to the aforementioned aims, principles and purposes.

FIFTH, that the Association represents the collective will of the nations of South-East Asia to bind themselves together in friendship and cooperation and, through joint efforts and sacrifices, secure for their peoples and for posterity the blessings of peace, freedom and prosperity.

DONE in Bangkok on the Eighth Day of August in the Year One Thousand Nine Hundred and Sixty-Seven.

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# APPENDIX II

# The 1976 Declaration of ASEAN Concord

**A COMMON BOND EXISTING AMONG THE MEMBER STATES OF THE ASSOCIATION OF SOUTHEAST ASIAN NATIONS,**

The President of the Republic of Indonesia, the Prime Minister of Malaysia, the President of the Republic of the Philippines, the Prime Minister of the Republic of Singapore and the Prime Minister of the Kingdom of Thailand,

REAFFIRM their commitment to the Declarations of Bandung, Bangkok and Kuala Lumpur, and the Charter of the United Nations;

ENDEAVOUR to promote peace, progress, prosperity and the welfare of the peoples of member states;

UNDERTAKE to consolidate the achievements of ASEAN and expand ASEAN cooperation in the economic, social, cultural and political fields;

**DO HEREBY DECLARE:**

ASEAN cooperation shall take into account, among others, the following objectives and principles in the pursuit of political stability:

1. The stability of each member state and of the ASEAN region is an essential contribution to international peace and security. Each member state resolves to eliminate threats posed by subversion to its stability, thus strengthening national and ASEAN resilience.
2. Member states, individually and collectively, shall take active steps for the early establishment of the Zone of Peace, Freedom and Neutrality.
3. The elimination of poverty, hunger, disease and illiteracy is a primary concern of member states. They shall therefore intensify cooperation in economic and social development, with particular emphasis on the promotion of social justice and on the improvement of the living standards of their peoples.
4. Natural disasters and other major calamities can retard the pace of development of member states. They shall extend, within their capabilities, assistance for relief of member states in distress.
5. Member states shall take cooperative action in their national and regional development programmes, utilizing as far as possible the resources available in the ASEAN region to broaden the complementarity of their respective economies.
6. Member states, in the spirit of ASEAN solidarity, shall rely exclusively on peaceful processes in the settlement of intra-regional differences.
7. Member states shall strive, individually and collectively, to create conditions conducive to the promotion of peaceful cooperation among the nations of Southeast Asia on the basis of mutual respect and mutual benefit.
8. Member states shall vigorously develop an awareness of regional identity and exert all efforts to create a strong ASEAN community, respected by all, and respecting all nations on the basis of mutually advantageous relationships, and in accordance with the principles of self-determination, sovereign equality and non-interference in the internal affairs of nations.

**AND DO HEREBY ADOPT**

the following programme of action as a framework for ASEAN cooperation:

**A. POLITICAL**

1. Meeting of the Heads of Government of the member states as and when necessary.
2. Signing of the Treaty of Amity and Cooperation in Southeast Asia.
3. Settlement of intra-regional disputes by peaceful means as soon as possible.
4. Immediate consideration of initial steps towards recognition of and respect for the Zone of Peace, Freedom and Neutrality wherever possible.
5. Improvement of ASEAN machinery to strengthen political cooperation.

**B. ECONOMIC**

1. **Cooperation on Basic Commodities, particularly Food and Energy**

(i) Member states shall assist each other by according priority to the supply of the individual country's needs in critical circumstances, and priority to the acquisition of exports from member states, in respect of basic commodities, particularly food and energy.

(ii) Member states shall also intensify cooperation in the production of basic commodities particularly food and energy in the individual member states of the region.

2. **Industrial Cooperation**

(i) Member states shall cooperate to establish large-scale ASEAN industrial plants, particularly to meet regional requirements of essential commodities.

(ii) Priority shall be given to projects which utilize the available materials in the member states, contribute to the increase of food production, increase foreign exchange earnings or save foreign exchange and create employment.

3. **Cooperation in Trade**

(i) Member states shall cooperate in the fields of trade in order to promote development and growth of new production and trade and to improve the trade structures of individual states and among countries of ASEAN conducive to further development and to safeguard and increase their foreign exchange earnings and reserves.

(ii) Member states shall progress towards the establishment of preferential trading arrangements as a long term objective on a basis deemed to be at any particular time appropriate through rounds of negotiations subject to the unanimous agreement of member states.

(iii) The expansion of trade among member states shall be facilitated through cooperation on basic commodities, particularly in food and energy and through cooperation in ASEAN industrial projects.
(iv) Member states shall accelerate joint efforts to improve access to markets outside ASEAN for their raw material and finished products by seeking the elimination of all trade barriers in those markets, developing new usage for these products and in adopting common approaches and actions in dealing with regional groupings and individual economic powers.
(v) Such efforts shall also lead to cooperation in the field of technology and production methods in order to increase the production and to improve the quality of export products, as well as to develop new export products with a view to diversifying exports.

4. **Joint Approach to International Commodity Problems and Other World Economic Problems**
(i) The principle of ASEAN cooperation on trade shall also be reflected on a priority basis in joint approaches to international commodity problems and other world economic problems such as the reform of international trading system, the reform of international monetary system and transfer of real resources, in the United Nations and other relevant multilateral fora, with a view to contributing to the establishment of the New International Economic Order.
(ii) Member states shall give priority to the stabilisation and increase of export earnings of those commodities produced and exported by them through commodity agreements including bufferstock schemes and other means.

5. **Machinery for Economic Cooperation**
Ministerial meetings on economic matters shall be held regularly or as deemed necessary in order to:
(i) formulate recommendations for the consideration of Governments of member states for the strengthening of ASEAN economic cooperation;
(ii) review the coordination and implementation of agreed ASEAN programmes and projects on economic cooperation;
(iii) exchange views and consult on national development plans and policies as a step towards harmonizing regional development; and
(iv) perform such other relevant functions as agreed upon by the member Governments.

### C. SOCIAL

1. Cooperation in the field of social development, with emphasis on the well being of the low-income group and of the rural population, through the expansion of opportunities for productive employment with fair remuneration.

2. Support for the active involvement of all sectors and levels of the ASEAN communities, particularly the women and youth, in development efforts.

3. Intensification and expansion of existing cooperation in meeting the problems of population growth in the ASEAN region, and where possible, formulation of new strategies in collaboration with appropriate international agencies.

4. Intensification of cooperation among member states as well as with the relevant international bodies in the prevention and eradication of the abuse of narcotics and the illegal trafficking of drugs.

### D. CULTURAL AND INFORMATION

1. Introduction of the study of ASEAN, its member states and their national languages as part of the curricula of schools and other institutions of learning in the member states.

2. Support of ASEAN scholars, writers, artists and mass media representatives to enable them to play an active role in fostering a sense of regional identity and fellowship.

3. Promotion of Southeast Asian studies through closer collaboration among national institutes.

### E. SECURITY

Continuation of cooperation on a non-ASEAN basis between the member states in security matters in accordance with their mutual needs and interests.

### F. IMPROVEMENT OF ASEAN MACHINERY

1. Signing of the Agreement on the Establishment of the ASEAN Secretariat.

2. Regular review of the ASEAN organizational structure with a view to improving its effectiveness.

3. Study of the desirability of a new constitutional framework for ASEAN.

DONE at Denpasar, Bali, this twenty-fourth day of February in the year one thousand nine hundred and seventy-six.

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# APPENDIX III

# 1977 Agreement on ASEAN Preferential Trading Arrangements

**The Governments of the Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore and the Kingdom of Thailand.**

RECALLING the Declaration of ASEAN Concord signed in Bali, Indonesia on 24 February 1976, which provides that Member States shall take cooperative action in their national and regional development programmes, utilizing as far as possible the resources available in the ASEAN region to broaden the complementarity of their respective economies;

EMPHASIZING that preferential trading arrangements among ASEAN Member States will act as a stimulus to the strengthening of national and ASEAN economic resilience and the development of the national economies of the Member States by expanding investment and production opportunities, trade and foreign exchange earnings;

NOTING that the International Community has fully recognized the importance of encouraging the establishment of preferences among developing countries at the international, regional and sub-regional levels, particularly through the resolution of the United Nations General Assembly establishing the International Development Strategy for the Second UN Development Decade and the Declaration on the Establishment of a New International Economic Order; and the programme of Action for the Establishment of a New International Economic Order; the Declaration on Trade Expansion, Economic Cooperation and Regional Integration Among Developing Countries adopted at UNCTAD II and Resolution 92 (IV) of UNCTAD IV; as well as of the General Agreement on Tariffs and Trade, particularly Part IV, and decisions made in pursuance thereof;

NOTING further that developed and developing countries have taken some decisions to promote preferential arrangements among developing countries as well as between developed and developing countries in terms favourable to the latter;

HAVE AGREED to establish ASEAN Preferential Trading Arrangements as stipulated by the following provisions:—

### CHAPTER 1
**General Provisions**

**Article 1**

1. The respective Governments of ASEAN Member States on whose behalf

the present Agreement is accepted, hereinafter referred to as the "Contracting States", have agreed to extend trade preferences to each other in accordance with the provisions of this Agreement and the rules, regulations and decisions agreed within its framework.

2. The contracting States agree to establish Preferential Trading Arrangements among them through the adoption of instruments, as may be appropriate, for ASEAN trade expansion.

3. Upon entry into force of this Agreement, concessions on products originating from all Contracting States agreed upon among them through rounds of negotiations shall be implemented by them in accordance with the provisions of this Agreement and any other supplementary agreements and/or contracts which may be concluded within the context of the Preferential Trading Arrangements on the individual products or groups of products.

4. The Contracting States agree that the Preferential Trading Arrangements among them shall be implemented in the spirit of ASEAN cooperation and mutual benefits.

#### Article 2

Contracting States shall cooperate through mutual assistance in respect of basic commodities, particularly food and energy; provision of market support for the products of the ASEAN industrial projects; expansion of intra-ASEAN trade and increase in the utilization of raw materials available in the Contracting States.

### CHAPTER II
### Instruments and definition of preferential trading arrangements

#### Article 3

The Contracting States agree to adopt the following instruments for Preferential Trading Arrangements: long-term quantity contracts; purchase finance support at preferential interest rates; preference in procurement by Government entities; extension of tariff preferences; liberalization of non-tariff measures on a preferential basis; and other measures.

#### Article 4

The Preferential Trading Arrangements shall be applied to Basic Commodities particularly rice and crude oil; products of the ASEAN industrial projects; products for the expansion of intra-ASEAN trade; and other products of interest to Contracting States.

#### Article 5

Long-term Quantity Contracts shall apply to selected products subject to specific agreements negotiated among the Contracting States or their nominated agencies. Long-term contracts shall be for a period of three years to five years depending on the products and quantities to be agreed upon subject to annual review where appropriate. However, this provision does not preclude contracts of less than three years as may be agreed upon by the Contracting States.

#### Article 6

Purchase finance support at preferential interest rates may be applied to either exports to or imports from Contracting States of selected products of ASEAN domestic origin to be covered by the Preferential Trading Arrangements.

#### Article 7

1. Pre-tender notices for international tenders in respect of procurement by Government entities should be sent to the Missions of the Contracting States in the relevant ASEAN capital.

2. Subject to such provisions as may be embodied in supplementary agreements on Government procurement and to the rules of origin to be subsequently decided, Contracting States shall accord each other a preferential margin of 2½ % which should not exceed US$40,000 worth of preferences per tender in respect of international tenders for Government procurement of goods and auxiliary services from united loans submitted by ASEAN countries vis-a-vis non-ASEAN countries.

3. The preferential margin should be applied on the basis of the lowest evaluated and acceptable tender.

#### Article 8

1. An effective ASEAN margin of tariff preference should be accorded on a product-by-product basis.

2. Where tariff preferences have been negotiated on multilateral or bilateral basis, the concessions so agreed should be extended to all Contracting States on an ASEAN most-favoured-nation basis, except where special treatment is accorded to products of ASEAN industrial projects.

3. In the negotiations on tariff preferences, considerations for the balancing of preferences should take into account the possibility of using other instruments of preferential trading arrangements.

4. The effective ASEAN margin of tariff preferences to be accorded to the selected products should take into account existing levels of tariffs in the respective Contracting States.

#### Article 9

Without prejudice to the provisions in Articles 5, 6, 7 and 8, the Contracting States may decide on other preferences as may be mutually agreed upon.

### CHAPTER III
### Preferential treatment of the products of ASEAN industrial projects and industrial complementation schemes

#### Article 10

1. Notwithstanding the provisions of Articles 5, 6, 7, 8, 9 and 15 of this Agreement, the Contracting States shall establish special preferential trading arrangements in respect of products of ASEAN industrial projects which shall be embodied in supplementary agreements. Such supplementary agreements shall include the provision that trade preferences shall be extended exclusively to the products of the ASEAN industrial projects within agreed time frames and subject to such other conditions as may be set forth in the supplementary agreements.

2. The products of the ASEAN Industrial Complementation Projects shall qualify for preferential trading arrangements, provided that these individual industrial complementation schemes or projects fall within the guidelines approved by competent Committees of ASEAN Economic Ministers and that the specific schemes or projects are approved by the Committee on Industry, Minerals and Energy.

### CHAPTER IV
### Maintenance of concessions

#### Article 11

Contracting States shall not diminish or nullify any of the concessions as agreed upon through the application of any new charge or measure restricting trade, except in cases provided for in this Agreement.

### CHAPTER V
### Emergency measures

#### Article 12

1. If, as a result of the implementation of this Agreement, imports of a particular product eligible for Preferential Trading Arrangements are increasing in such a manner as to cause or threaten to cause serious injury to sectors producing like or similar products in the importing Contracting States, the importing Contracting State may suspend provisionally and without discrimination, the preferences included in this Agreement.

2. Without prejudice to existing international obligations, a Contracting State, which finds it necessary to institute or intensify quantitative restrictions or other measures limiting imports with a view to forestalling the threat of or stopping a serious decline in its monetary reserves or limiting exports due to serious decline in supplies shall endeavour to do so in a manner which safeguards the value of the concessions agreed upon.

3. Where, however, emergency measures are taken in pursuance to this Article, immediate notice of such action must be given to the Committee referred to in Article 13 and such action may be the subject of consultations as provided for in Article 14.

### CHAPTER VI
### Institutional arrangements

#### Article 13

The ASEAN Committee on Trade and Tourism (hereinafter referred to as THE COMMITTEE) is hereby directed and authorized to conduct trade negotiations within the framework of this Agreement and to review and supervise the implementation of the Agreement. In respect of all matters concerning the implementation of the Agreement, all decisions of the Committee shall be taken by consensus. The ASEAN Secretariat shall monitor the implementation of the Agreement pursuant to Article III. 2.8 of the Agreement on the Establishment of the ASEAN Secretariat. [1]

**CHAPTER VII**
**Consultations**

**Article 14**

1. Each Contracting State shall accord adequate opportunity for consultations regarding such representations as may be made by another Contracting State/States with respect to any matter affecting the implementation of this. Agreement. The Committee may, at the request of the Contracting State/States, consult with any other Contracting State/States in respect of any matter for which it has not been possible to find a satisfactory solution during previous consultations.

2. If any Contracting State should consider that any other Contracting State has not carried out its obligations under this Agreement so that it nullifies or impairs any benefit accruing to it, the affected Contracting State, with a view to the satisfactory adjustments of the matter, may make representations or proposals to the other Contracting State concerned which thus approached shall give due consideration to the proposals made to it.

3. If no satisfactory adjustment is effected between the Contracting States concerned within 60 days from the date on which such representation or request for consultation was made, the matter may be referred to the Committee who shall consult with the Contracting States concerned and arrive at a solution mutually acceptable to the States concerned. Where the circumstances are serious enough, a Contracting State may temporarily suspend the application of the concession to the Contracting State/States concerned until a mutually satisfactory solution is arrived at. A Contracting State suspending the concession shall give written notification to the other Contracting States within 30 days prior to such action.

**CHAPTER VIII**
**Rules of origin**

**Article 15**

Products mentioned in Article 4 of this Agreemnt shall be eligible for preferential treatment if they satisfy the Rules of Origin set out in Annex I which is an integral part of this Agreement.

**CHAPTER IX**
**General exceptions**

**Article 16**

Nothing in this Agreement shall prevent any Contracting State, from taking action and adopting measures which it considers necessary for the protection of its national security, the protection of public morality, the protection of human, animal and plant life and health, and the protection of articles of artistic, historic and archaeological value.

**CHAPTER X**
**Miscellaneous and final provisions**

**Article 17**

1. This Agreement shall enter into force on the 30th day after the deposit of the Fifth Instrument of Ratification.

2. This Agreement may not be signed with reservation nor shall reservations be admitted at the time of ratification.

3. All Articles of this Agreement may be modified through amendments to this Agreement agreed upon by consensus. All amendments shall become effective upon acceptance by all Contracting States.

4. This Agreement shall be deposited with the Secretary-General of the ASEAN Secretariat who shall promptly furnish a certified copy thereof to each Contracting State.

5. Each Contracting State shall deposit its Instrument of Ratification with the Secretary-General of the ASEAN Secretariat who shall likewise promptly inform each Contracting State of such deposit.

IN WITNESS WHEREOF, the undersigned being duly authorized thereto by their respective Governments have signed this Agreement on ASEAN Preferential Trading Arrangements. [2]

## Annex I

### RULES OF ORIGIN FOR THE ASEAN PREFERENTIAL TRADING ARRANGEMENTS

For determining the origin of products eligible for preferential concessions under the Agreement on ASEAN Preferential Trading Arrangements, the following Rules shall be applied:

**Rule 1. Originating Products —**
Products covered by preferential trading arrangements within the framework of this Agreement, imported into the territory of a Contracting State from another Contracting State which are consigned directly within the meaning of Rule 5 hereof, shall be eligible for preferential concessions if they conform to the origin requirement under any one of the following conditions:
(a) Products wholly produced or obtained in the exporting Contracting State as defined in Rule 2; or
(b) Products not wholly produced or obtained in the exporting Contracting State, provided that the said products are eligible under Rule 3 or Rule 4.

**Rule 2. Wholly Produced or Obtained —**
Within the meaning of Rule 1(a), the following shall be considered as wholly produced or obtained in the exporting Contracting State :
(a) mineral products extracted from its soil, its water or its seabeds;
(b) agricultural products harvested there;
(c) animals born and raised there;
(d) products obtained from animals referred to in paragraph (c) above;
(e) products obtained by hunting or fishing conducted there;
(f) products of sea fishing and other marine products taken from the sea by its vessels; *1/ 3/*
(g) products processed and/or made on board its factory ships *2/ 3/* exclusively from products referred to in paragraph (f) above;
(h) used articles collected here, fit only for the recovery of raw materials;
(i) waste and scrap resulting from manufacturing operations conducted there;
(j) goods produced there exclusively from the products referred to in paragraph (a) to (i) above.

*1/ "vessels" — shall refer to fishing vessels engaged in commercial fishing, registered in a Contracting State and operated by a citizen or citizens or government of such Contracting State, or partnership, corporation or association, duly registered in such Contracting State, at least 60% of the equity of which is owned by a citizen or citizens of such Contracting State or 75% by citizens or governments of the Contracting States, provided that the conduct of fishing activities or operations in the territorial waters of any of the Contracting States, shall be subject to the provisions of the constitution and existing laws of the respective Contracting States.*

*2/ "factory ships" — shall refer to special types of vessels equipped with processing facilities and able to do processing operations offshore and in the high seas, registered in a Contracting State and operated by a citizen or citizens or government of such Contracting State, or partnership, corporation or association, duly registered in such Contracting State, at least 60% of the equity of which is owned by a citizen or citizens or government of such Contracting State, or 75% by citizens or governments of the Contracting States, provided that the conduct of fishing activities or operations in the territorial waters of any of the Contracting States, shall be subject to the provisions of the constitution and existing laws of the respective Contracting States.*

*3/ In respect of vessels or factory ships operated by government agencies, the requirement of flying the flag of a Contracting State does not apply.*

**Rule 3. Not wholly produced or obtained —**
(a) (i) Subject to sub-paragraph (ii) below, for the purpose of implementing the provisions of Rule 1 (b) and subject to the provisions of Rule 4, products worked on and processed as a result of which the total value of the materials, parts on produce originating from non-ASEAN countries or of undetermined origin used does not exceed 50% of the FOB value of the products produced or obtained and the final process of manufacture is performed

1. Not reproduced herein. The ASEAN Secretariat is situated in Jakarta (Indonesia).
2. The five ASEAN Foreign Ministers have signed the Agreement on ASEAN Preferential Trading Arrangements in Manila on February 24, 1977.

within the territory of the exporting Contracting State.
(ii) In respect of Indonesia, the percentage referred to in sub-paragraph (i) above is 40%. On certain categories of manufactured products to be agreed upon from time to time, the requirement of 50% of non-ASEAN content may apply.
(b) In respect of the ASEAN industrial projects, the percent criterion of Rule 3 (a) may be waived.
(c) The value of the non-originating materials, parts or produce shall be:—
(1) The CIF value at the time of importation of the products or importation can be proven; or
(2) The earliest ascertainable price paid for the products of undetermined origin in the territory of the Contracting State where the working or processing takes place.

**Rule 4. Cumulative Rule of Origin —**
Products which comply with origin requirements provided for in Rule 1 and which are used in a contracting state as inputs for a finished product eligible for preferential treatment in another Contracting State/States shall be considered as a product originating in the Contracting State where working or processing of the finsished product has taken place provided that the aggregate ASEAN content of the final product is not less than 60%.

**Rule 5. Direct Consignment —**
The following shall be considered as directly consigned from the exporting Contracting State to the importing Contracting State:
(a) if the products are transported without passing through the territory of any other non-ASEAN country;
(b) the products whose transport involves transit through one or more intermediate non-ASEAN countries with or without transhipment or temporary storage in such countries, provided that:
(1) the transit entry is justified for geographical reason or by considerations related exclusively to transport requirements;
(2) the products have not entered into trade or consumption there; and
(3) the products have not undergone any operation there other than unloading and reloading or any operation required to keep them in good condition.

**Rule 6. Treatment of packing —**
(a) Where for purposes of assessing customs duties a Contracting State treats products separately from their packing, it may also, in respect of its imports consigned from another Contracting State, determine separately the origin of such packing.
(b) Where paragraph (a) above is not applied, packing shall be considered as forming a whole with the products and no part of any packing required for their transport or storage shall be considered as having been imported from outside the ASEAN region when determining the origin of the products as a whole.

**Rule 7. Certificate of Origin —**
A claim that products shall be accepted as eligible for preferential concession shall be supported by a Certificate of Origin issued by a government authority designated by the exporting Contracting State and notified to the other Contracting States in accordance with the Certification Procedures to be developed and approved by the Committee on Trade and Tourism.

**Rule 8. Review —**
These Rules may be reviewed as and when necessary upon request of a Contracting State and may be open to such modification as may be agreed upon by Ministers responsible for trade of the Contracting States.

# APPENDIX IV

## FIRST SCHEDULE OF TARIFF REDUCTIONS ON 71 COMMODITIES FOR ASEAN PREFERENTIAL TRADING ARRANGEMENTS

| COUNTRY | BTN CODE | DESCRIPTION OF PRODUCT | EXISTING RATE | TRADE PREFERENCES | |
|---|---|---|---|---|---|
| | | | | Margin of Preference on Existing Rate | Other preferences |
| Indonesia | Ex 40.11.70 | Tyres and tubes for off the road vehicles (tractors, graders, earth movers, industrial) **except sizes (i) 12.4/11 x 28 (ii) 16.9/14 x 31** | Rp 340/kg | 10% | |
| | 28.56.10 | Calcium carbide | 15% | 10% | |
| | 25.23.20 | Portland cement | Rp 3000/mt | 0% | Priority import from the Philippines for semester 1 1978 amount to 180.500 MT |
| | Ex 87.12.20 | Parts and accessories of articles falling within heading No. 87.09 (Motor cycles, autocycles and cycles fitted with an auxiliary motor, with or without side cars; side cars of all kinds) **except chains** | 60% | 10% | |

[continued]

| COUNTRY | BTN CODE | DESCRIPTION OF PRODUCT | EXISTING RATE | TRADE PREFERENCES | |
|---|---|---|---|---|---|
| | | | | Margin of Preference on Existing Rate | Other preferences |
| | 90.28.00 | Electrical measuring, checking, analysing or automatically controlling instruments and apparatus | 20% | 10% | |
| | 25.23.90 | Cement Clinker | Rp 3000/mt | | Priority purchase |
| | 10.05.01 | Maize, other than seeds | 50% | 10% | |
| | Ex 20.02.90 | Canned vegetables | 5% | 10% | |
| | 82.09.10 | Knives with cutting blades, for tapping rubber or for incising rubber trees | 20% | 10% | |
| | 71.02.10 | Industrial diamonds | 20% | 10% | |
| | 48.08.00 | Filter blocks of paper pulp | 20% | 10% | |
| | Ex 48.15.95 | Facial tissues | 60% | 10% | |
| | Ex 48.21.90 | Sanitary towels | 60% | 10% | |
| | 10.07.20 | Sorghum | 5% | 10% | |
| | 11.01.90 | White rice flour | 5% | 10% | |
| Malaysia | 59.04.400 | Twine, cordage, ropes and cables, plaited or not of manila hemp | 15% | 15% | |
| | 84.51.100 | Portable typewriters | 25% | 10% | |
| | 84.51.210 | Typewriters electric | 25% | 10% | |
| | Ex 19.03.000 | **Vermicilli and noodles made from rice** | $6/cwt | 15% | Quota relaxation to be considered |
| | 28.42.100 | Soda ash | 0% | Binding 0% | |
| | 01.02 | Live animals (cattle | 0% | Binding 0% | |
| | 07.01 | Vegetables | | | |
| | 07.01.100 | Potatoes | 0% | Binding 0% | |
| | 21.02.300 | Onions | 0% | Binding 0% | |
| | 21.02.100 | Extracts, concentrate of coffee | 20c/lb. | Binding 20c/lb. | |
| | 10.06 | Rice | 0% | | Annual contract |
| | 10.05.000 | Maize | 0% | | Annual contract |
| | 25.01.900 | Other salts | 0% | Binding 0% | |
| | 25.20.000 | Gypsum | 0% | Binding 0% | |
| | 17.01.103 | Raw sugar (polarisation 95° - 98°) | $156.8/ton | | Annual contract |
| | 03.02.150 | Sharks fin | 20% | 10% | |
| Philippines | Ex 27.13 | Paraffin wax | 20% | 10% | |
| | Ex 70.10 B | **Glass jars for baby foods** | 50% | 20% | |
| | Ex 84.51 | **Portable electric typewriters** | 20% | 20% | |
| | 70.06 | Cast, rolled, drawn or blown glass (including flashed or wired glass) in rectangles, surface ground or polished, but not further worked | 70% | 30% | |
| | B | Other | | | |

[continued]

| COUNTRY | BTN CODE | DESCRIPTION OF PRODUCT | EXISTING RATE | TRADE PREFERENCES | |
|---|---|---|---|---|---|
| | | | | Margin of Preference on Existing Rate | Other preferences |
| | 02.01 | Meat or offal from bovine cattle | 70% | 30% | |
| | 10.05 | Maize | 70% | 20% | |
| | Ex 07.05 B | Mongo beans (green and yellow) | 50% | 20% | |
| | Ex 15.07 A | Palm oil (crude and refined) | 20% | 20% | |
| | Ex 15.07 B | Palm kernel oil | 50% | 20% | |
| | 25.20 B | Crude gypsum | 20% | 20% | |
| | 27.01 | Anthracite coal | 10% | 20% | |
| | Ex 85.24 | Graphite and carbon electrode | 30% | 10% | |
| | Ex 40.11 A | Tractor tyres | 30% | 10% | |
| | Ex 84.62 | Ball bearings | 10% | 10% | |
| Singapore | 61.02.220 | Kain lepas and kain sarong batek | 15% | 10% | |
| | 33.06.510 | Shampoo | 20% | 0% Binding | |
| | 17.01.100 | Beet sugar and cane sugar, solids: raw | $308.56/mt | | LTQC to the Philippines for 12,000-24,000 m. tons. Exemption of import duty on LTQC. |
| | 42.02.910 | Handbags, pochettes, purses, wallets, briefcases, portfolios, scholars satchels: other than articles falling under 42.02.110, 120 and 200 | Nil | 5% absolute | |
| | 60.04.910 | Undergarments, cotton knitted or crocheted not elastic | 15% | 10% | |
| | 60.04.990 | Undergarments, not wholly of cotton | 15% | 10% | |
| | 60.05.000 | Outergarments, other articles not knitted or crocheted not elastic | 15% | 10% | |
| | 61.04.100 | Undergarments, infants, not knitted or crocheted | 15% | 10% | |
| | 61.01.900 | Outergarments for men excluding sarongs and dhoties | 15% | 10% | |
| | 61.02.100 | Outergarments for infants | 15% | 10% | |
| | 61.03.100 | Shirts not knitted or crocheted | 15% | 10% | |
| | 61.03.900 | Men's and boys' undergarments, other | 15% | 10% | |
| | 61.05.210 | Handkerchiefs, wholly of cotton | 15% | 10% | |
| | 61.09.200 | Brassieres | 15% | 10% | |
| Thailand | 29.42.10 | Quinine including its salts | 0% | 0% | 3-year LTQC to Indonesia |
| | 15.13.01 | Margarine | 60% | 15% | |
| | 59.04.14 | Twine, cordage, ropes and cables, plaited or not of manila hemp | 15% | 20% | |
| | 84.62.01 | Ball bearings | 15% | 20% | |
| | 44.04 | Sawn timber | 1% | 30% | |

[continued]

| COUNTRY | BTN CODE | DESCRIPTION OF PRODUCT | EXISTING RATE | TRADE PREFERENCES | |
|---|---|---|---|---|---|
| | | | | Margin of Preference on Existing Rate | Other preferences |
| | 44.05.39 | Other lumber non-coniferous | 2% | 10% | |
| | 07.01 | Vegetables | 50% or Bht. 5.00/kg | 30% | |
| | 07.06 | Vegetables | 50% | 30% | |
| | 78.02.01 | Lead base rods solder | 15% | 10% | |
| | 38.11.26 | Insecticides | 30% | 10% | |
| | 09.08.21 | Nutmeg not powdered | 25% or Bht 2.20/kg | 10% | |
| | 09.04.22 | Chilly not powdered | 25% or Bht 2.20/kg | 10% | |
| | 27.13.01 | Paraffin wax | 30% or Bht 1.10/kg | 10% | |
| | 38.11.29 | Other kinds of chemicals for agricultural use | 5% | 10% | |

## TABLE IV

## SINGAPORE

**Imports by country of origin and commodity groups. January – September 1977**
**Commodity groups (value in S$ thousand CIF)**

| Country of Origin | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **E.E.C.** | | | | | | | | | | | |
| Belgium and Luxembourg | 7,053 | 4 | 212 | 824 | 371 | 11,619 | 20,783 | 15,845 | 3,334 | 4,515 | 64,560 |
| Denmark | 14,613 | 212 | 1,104 | – | 10 | 10,313 | 6,901 | 11,118 | 3,395 | 2,659 | 50,325 |
| France | 5,041 | 32,690 | 172 | 8,329 | 675 | 34,170 | 25,587 | 92,668 | 24,541 | 4,601 | 228,475 |
| German Fed. Rep. | 2,342 | 716 | 9,604 | 778 | 1,407 | 80,843 | 74,109 | 375,679 | 60,750 | 23,644 | 629,872 |
| Ireland | 3,353 | 127 | | – | | 1,144 | 308 | 930 | 783 | 6 | 6,651 |
| Italy | 1,999 | 919 | 369 | 63 | 53 | 11,792 | 44,760 | 87,598 | 21,404 | 1,058 | 170,015 |
| Netherlands | 15,970 | 1,164 | 720 | 6,715 | 1,410 | 23,561 | 12,507 | 80,881 | 15,849 | 16,646 | 175,423 |
| United Kingdom | 24,130 | 16,638 | 2,645 | 15,247 | 1,309 | 129,569 | 103,718 | 283,903 | 67,408 | 38,595 | 683,162 |
| Total | 74,501 | 52,471 | 14,827 | 31,957 | 5,236 | 303,009 | 288,673 | 948,621 | 197,464 | 91,725 | 2,008,484 |
| Percentage of total imports | | | | | | | | | | | 10.7% |
| **E.F.T.A.** | | | | | | | | | | | |
| Austria | 306 | 96 | 384 | 56 | | 1,248 | 6,992 | 7,192 | 4,146 | 46 | 20,466 |
| Finland | 1 | | 1 | | | 2,375 | 6,123 | 550 | 73 | 72 | 9,194 |
| Iceland | 12 | | | | | | | | 47 | | 59 |
| Norway | 754 | 210 | 674 | 59 | 116 | 3,759 | 7,449 | 46,789 | 1,749 | 3,094 | 64,654 |
| Portugal | 137 | 187 | 247 | | 1 | 297 | 1,640 | 1,276 | 257 | 105 | 4,146 |
| Sweden | 42 | 2 | 29 | 69 | | 1,420 | 24,692 | 58,125 | 2,991 | 6,486 | 93,856 |
| Switzerland and Liechtenstein | 2,711 | 142 | 94 | 3 | | 31,598 | 11,609 | 15,336 | 90,667 | 1,333 | 153,493 |
| Total | 3,962 | 637 | 1,428 | 188 | 117 | 40,697 | 58,504 | 129,269 | 99,931 | 11,136 | 345,868 |
| Percentage of total imports | | | | | | | | | | | 1.8% |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

**[continued]**

## TABLE IV (continued)

| Country of Origin | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **OTHER WESTERN EUROPE** | | | | | | | | | | | |
| Greece | 572 | 169 | | 16,795 | | 57 | 9 | 60 | 20 | 5,102 | 22,784 |
| Spain | 2,952 | 189 | 97 | | 97 | 1,203 | 5,219 | 8,301 | 2,116 | 72 | 20,245 |
| Turkey | 173 | 3 | 1,091 | | | 3 | 69 | | – | 1 | 1,340 |
| Yugoslavia | | | | | | 148 | 689 | 3,000 | 46 | 33 | 3,916 |
| Others | | | | | | | | 187 | 58 | 253 | 499 |
| Total | 3,697 | 361 | 1,188 | 16,795 | 97 | 1,411 | 5,986 | 11,548 | 2,240 | 5,461 | 48,783 |
| Percentage of total imports | | | | | | | | | | | 0.3% |
| **EASTERN EUROPE** | | | | | | | | | | | |
| Bulgaria | 8 | 4 | | | | 991 | 83 | 2,046 | 1 | 1 | 3,134 |
| Czechoslovakia | 284 | | | | | 444 | 7,420 | 1,600 | 1,298 | 2 | 11,048 |
| German Dem. Rep. | | | | 6 | 262 | 156 | 4,045 | 1,843 | 294 | 7 | 6,614 |
| Hungary | 19 | 45 | | | | 853 | 326 | 823 | 159 | | 2,207 |
| Poland | 1,002 | | | | | 1,900 | 3,122 | 5,252 | 78 | 51 | 11,405 |
| Romania | 1,444 | | | | | 10,446 | 2,079 | 7 | | | 13,976 |
| U.S.S.R. | 17,677 | 32 | 12,278 | | | 608 | 19,096 | 1,278 | 508 | 210 | 51,686 |
| Total | 20,433 | 81 | 12,278 | 6 | 262 | 15,380 | 36,172 | 12,849 | 2,338 | 270 | 100,069 |
| Percentage of total imports | | | | | | | | | | | 0.6% |
| **SOUTH EAST ASIA** | | | | | | | | | | | |
| Brunei | 272 | | 938 | 99,485 | | 4 | 1,120 | 3,083 | 538 | 1,526 | 106,965 |
| Burma | 22,513 | | 32,873 | 4,335 | | | 935 | 1 | 34 | 72 | 60,784 |
| Cambodia | | | 345 | | | | | | | | 345 |
| Laos | 6,197 | | 94 | | | | | | | | 6,291 |
| Malaysia (Peninsular) | 211,441 | 11,661 | 1,135,755 | 36,500 | 318,700 | 44,924 | 207,859 | 225,452 | 90,652 | 3,436 | 2,286,381 |
| Philippines | 66,291 | 85 | 325 | 8,100 | 15,162 | 3,025 | 9,561 | 21,838 | 7,981 | 522 | 132,890 |
| Sabah (East Malaysia) | 14,149 | | 58,223 | 2 | 1,347 | 16 | 1,027 | 5,073 | 23 | 1,809 | 81,669 |
| Sarawak (East Malaysia) | 88,397 | 20 | 50,162 | 99,280 | 1,021 | 5 | 518 | 980 | 98 | 3,375 | 243,856 |
| Thailand | 215,978 | 1,487 | 111,446 | 556 | 86 | 2,588 | 45,651 | 53,787 | 9,609 | 4,118 | 445,306 |
| Vietnam Socialist Rep. of | 5,076 | | 18,429 | – | 158 | 219 | 359 | 18 | 33 | 22 | 24,314 |
| Other | 4 | | | | | | | | | | 4 |
| Total | 630,317 | 13,254 | 1,408,590 | 248,279 | 336,474 | 50,782 | 267,028 | 310,232 | 108,968 | 14,880 | 3,388,805 |
| Percentage of imports | | | | | | | | | | | 18.1% |
| **NORTH EAST ASIA** | | | | | | | | | | | |
| China | 140,701 | 12,484 | 36,704 | 3,145 | 1,102 | 36,936 | 167,304 | 32,376 | 72,722 | 261 | 503,736 |
| Hongkong | 13,272 | 332 | 8,303 | 7 | 1,079 | 24,775 | 142,416 | 91,555 | 163,462 | 29,644 | 474,846 |
| Japan | 52,326 | 1,426 | 25,214 | 11,705 | 2,957 | 194,729 | 977,345 | 1,455,753 | 354,930 | 36,376 | 3,112,762 |
| Korea (North) | 3,154 | | 1,856 | | | 3,715 | 7,004 | 4 | 24 | – | 15,757 |
| Korea (South) | 9,188 | 1,968 | 14,758 | 21,146 | 44 | 13,146 | 98,487 | 39,461 | 10,098 | 292 | 208,588 |
| Macau | | 199 | | | 2 | 28 | 221 | | 3,634 | | 4,084 |
| Taiwan | 49,217 | 47 | 4,901 | 2,146 | 15 | 23,471 | 175,461 | 122,319 | 52,714 | 3,328 | 433,620 |
| Total | 267,859 | 16,457 | 91,736 | 38,149 | 5,198 | 296,800 | 1,568,239 | 1,741,468 | 657,585 | 69,901 | 4,753,392 |
| Percentage of imports | | | | | | | | | | | 25.4% |
| **SOUTH ASIA** | | | | | | | | | | | |
| Afghanistan | 61 | | 2,129 | | | | 99 | | | | 2,289 |
| Bangladesh | 5,019 | | 103 | | | 26 | 2,000 | 558 | 1 | 1,159 | 8,866 |
| Christmas Is. | | | 2,245 | | | | | – | | 110 | 2,355 |
| India | 46,641 | 210 | 16,809 | 8 | 115 | 5,712 | 39,188 | 12,141 | 17,734 | 1,713 | 140,271 |
| Nepal | 6,383 | | 652 | | | | 107 | 120 | 4 | 1 | 7,267 |
| Pakistan | 8,335 | | 2,040 | 10,655 | | 154 | 10,376 | 86 | 603 | 297 | 32,546 |
| Sri Lanka | 12,711 | 15 | 6,428 | 44,117 | | 251 | 2,108 | 86 | 144 | 131 | 25,991 |
| Others | 567 | 23 | 332 | | | | | – | | – | 923 |
| Total | 79,717 | 249 | 30,738 | 14,780 | 115 | 6,142 | 53,878 | 12,991 | 18,485 | 3,411 | 220,506 |
| Percentage of total imports | | | | | | | | | | | 1.1% |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

**[continued]**

## TABLE IV (continued)

| Country of Origin | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **WEST ASIA** | | | | | | | | | | | |
| Aden | | | | | | | | | | 1 | 1 |
| Bahrein | | | | 198,257 | | | 69 | 450 | 15 | 171 | 198,962 |
| Cyprus | | 15 | | | | | | | | | 15 |
| Iran | 2,329 | | 421 | 746,527 | | | 1,171 | | 1 | 122 | 750,571 |
| Iraq | 1,256 | | | 464,536 | | | | | | 537 | 466,328 |
| Israel | 9,638 | 2 | 343 | 19,468 | 2 | 15,015 | 3,684 | 6,135 | 483 | 11,595 | 66,365 |
| Jordan | | | | | | | | | — | | — |
| Kuwait | — | | 5 | 205,424 | | | | | — | 1,457 | 206,886 |
| Lebanon | 114 | | | | | | | | | 15 | 129 |
| Saudi Arabia | 32 | | | 2,679,885 | | — | 85 | 3 | 5 | 287 | 2,680,297 |
| Syria | | | 2,059 | | | 5 | | | | | 2,064 |
| United Arab Emirates | 330 | | | 42,855 | | 3 | 132 | 233 | 100 | 340 | 43,992 |
| Others | 1,224 | | | 7,391 | 57 | 307 | 2 | | — | 4 | 8,985 |
| Total | 14,921 | 17 | 2,828 | 4,364,342 | 59 | 15,331 | 5,143 | 6,821 | 603 | 14,530 | 4,424,595 |
| Percentage of total imports | | | | | | | | | | | 23,6% |
| **NORTH AFRICA** | | | | | | | | | | | |
| Algeria | | | 44 | | | | 490 | | | 2 | 536 |
| Egypt | 5,070 | | 109 | | | | 311 | 1 | 37 | 52 | 5,580 |
| Libya | | | | | | | | | | 21 | 21 |
| Morocco | 4,070 | | 46 | | — | 164 | 414 | | | — | 4,695 |
| Sudan | 13 | | 3,207 | 7,436 | | | | | | — | 10,656 |
| Tunisia | 32 | | | | | | | | | | 32 |
| Others | 1 | | 1 | | | | | | | 4 | 6 |
| Total | 9,186 | | 3,406 | 7,436 | — | 164 | 1,215 | 1 | 37 | 80 | 21,526 |
| Percentage of total imports | | | | | | | | | | | 0.1% |
| **OTHER AFRICA** | | | | | | | | | | | |
| Ghana | 114 | | 124 | | | | 903 | | 1 | 2 | 1,144 |
| Ivory Coast | | | 18 | | | | | | | | 18 |
| Kenya | 13,245 | 2 | 9,668 | 30,378 | | 2,073 | 13,117 | 4 | 3 | 113 | 68,601 |
| Liberia | | | | | | | | | | 7 | 7 |
| Malagasy Rep. | 4,514 | | | 5,145 | | | | | 5 | | 9,665 |
| Mauritius | 60 | | 2 | | — | — | | 2 | 2 | | 66 |
| Mozambique | 4,400 | | 237 | 6,851 | | | 79 | | — | — | 11,567 |
| Nigeria | 51 | | | | | | | | | 31 | 82 |
| Tanzania | 8,111 | | 13,371 | 6,984 | 1 | | 412 | 96 | 2 | 6 | 28,984 |
| Uganda | 363 | | 2,343 | | | | | | | | 2,706 |
| Zambia | | | 131 | | | | 1 | | | 1 | 133 |
| Others | 1,369 | | 8,260 | | 5,313 | 3,394 | 3,203 | 1 | 1 | 242 | 21,782 |
| Total | 32,228 | 2 | 34,155 | 49,358 | 5,314 | 5,467 | 17,716 | 102 | 14 | 404 | 144,756 |
| Percentage of total imports | | | | | | | | | | | 0.8% |
| **NORTH AMERICA** | | | | | | | | | | | |
| Canada | 6,165 | 168 | 7,387 | | 55 | 15,632 | 29,152 | 20,470 | 2,273 | 1,578 | 82,880 |
| U.S.A. | 106,521 | 18,969 | 67,457 | 13,260 | 728 | 193,658 | 170,235 | 1,647,573 | 152,315 | 29,018 | 2,399,734 |
| Total | 112,686 | 19,136 | 74,845 | 13,260 | 783 | 209,291 | 199,387 | 1,668,043 | 154,588 | 30,596 | 2,482,613 |
| Percentage of total imports | | | | | | | | | | | 13.3% |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

**[continued]**

## TABLE IV (continued)

| Country of Origin | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **L.A.F.T.A.** | | | | | | | | | | | |
| Argentina | 43,058 | | 15,024 | | | 44 | 236 | 306 | 2 | 9 | 58,679 |
| Brazil | 70,389 | 763 | 2,974 | | 979 | 1,456 | 2,112 | 1,695 | 375 | 489 | 81,234 |
| Chile | 623 | | 209 | | | | 1,053 | | | — | 1,885 |
| Colombia | 198 | | 711 | | | 228 | 2,038 | 32 | | | 3,206 |
| Ecuador | 982 | | | | | | | | | — | 982 |
| Mexico | 5,547 | 341 | 304 | | 3 | 102 | 624 | 446 | 73 | 11 | 7,451 |
| Paraguay | 39 | | | | | 252 | 115 | | | 1 | 407 |
| Peru | | | | | | | 83 | | | 24 | 107 |
| Uruguay | 130 | | | | | | 49 | | 9 | | 187 |
| Venezuela | | | | 10,218 | | | 2,585 | | | 5 | 12,807 |
| Total | 120,966 | 1,104 | 19,222 | 10,218 | 983 | 2,082 | 8,894 | 2,480 | 458 | 538 | 166,945 |
| Percentage of total imports | | | | | | | | | | | 0.9% |
| **OTHER CENTRAL & SOUTH AMERICA** | | | | | | | | | | | |
| Cuba | 24 | 42 | | | | | | | | | 66 |
| Netherlands Antilles | | | | 14,686 | | 10 | 12 | | | — | 14,708 |
| Panama | 48 | | | 1 | | 130 | | 5,087 | — | 7 | 5,273 |
| Others | 814 | 228 | 1,658 | | | 1 | 8 | 89 | 20 | 9 | 2,828 |
| Total | 886 | 270 | 1,658 | 14,687 | | 141 | 20 | 5,176 | 20 | 16 | 22,876 |
| Percentage of total imports | | | | | | | | | | | 0.1% |
| **OCEANIA** | | | | | | | | | | | |
| Australia | 230,716 | 3,192 | 10,104 | 29,674 | 6,135 | 23,226 | 60,021 | 59,335 | 22,396 | 44,673 | 489,472 |
| Fiji | 22,034 | | | | | | — | | — | 65 | 22,098 |
| New Caledonia | | | | | | | 35 | 1 | | 1 | 38 |
| New Zealand | 45,627 | 22 | 208 | | 3,218 | 3,498 | 8,898 | 3,804 | 1,301 | 1,061 | 67,637 |
| Papua New Guinea | 1,770 | — | 5,236 | | | 34 | 12 | 374 | 221 | 52 | 7,699 |
| Western Samoa | 29 | | | | | | | — | | | 29 |
| Others | 332 | | 4,165 | | | | | | — | 29 | 4,526 |
| Total | 300,507 | 3,214 | 19,714 | 29,674 | 9,353 | 26,758 | 68,965 | 63,515 | 23,918 | 45,882 | 591,499 |
| Percentage of total imports | | | | | | | | | | | 3.2% |
| TOTAL | 1,671,867 | 107,251 | 1,716,612 | 4,839,129 | 363,990 | 973,454 | 2,579,822 | 4,913,116 | 1,266,649 | 288,828 | 18,720,718 |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

# TABLE V

# SINGAPORE

## Exports by country of destination and commodity groups. January – September 1977
## Commodity groups (value in S$ thousand FOB)

| Country of Destination | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **E.E.C.** | | | | | | | | | | | |
| Belgium and Luxembourg | 4,405 | | 35,212 | | | 4,025 | 7,424 | 4,591 | 5,623 | 2,731 | 64,011 |
| Denmark | 1,102 | – | 4,128 | | | 258 | 5,559 | 70,402 | 9,407 | 29,970 | 120,826 |
| France | 9,908 | 46 | 149,705 | 1 | 25 | 1,191 | 14,920 | 89,020 | 53,105 | 15,161 | 333,082 |
| German Fed. Rep. | 20,680 | – | 107,789 | 1 | 325 | 2,143 | 22,310 | 243,249 | 132,885 | 36,411 | 565,793 |
| Ireland | 301 | | 1,858 | | | 3 | 948 | 4,819 | 596 | 239 | 8,764 |
| Italy | 6,951 | 1 | 89,694 | | 2,866 | 440 | 8,319 | 50,964 | 7,506 | 16,760 | 183,500 |
| Netherlands | 25,347 | 18 | 78,512 | 7,505 | 10,994 | 1,866 | 11,160 | 63,209 | 29,062 | 56,081 | 283,753 |
| United Kingdom | 30,207 | 135 | 117,265 | 75 | 9,891 | 4,691 | 77,755 | 86,563 | 50,662 | 121,854 | 499,099 |
| Total | 98,901 | 200 | 584,164 | 7,582 | 24,009 | 14,616 | 148,394 | 612,817 | 288,846 | 279,209 | 2,058,828 |
| Percentage of total exports | | | | | | | | | | | 13.9% |
| **E.F.T.A.** | | | | | | | | | | | |
| Austria | 161 | | 330 | | | 15 | – | 2,347 | 6,706 | 133 | 9,692 |
| Finland | 107 | | 105 | | – | | 628 | 1,478 | 1,113 | 2,912 | 6,343 |
| Iceland | | | | | | – | 31 | 38 | 37 | | 107 |
| Norway | 222 | | 1,118 | | | 31 | 4,492 | 102,880 | 6,914 | 44,731 | 160,389 |
| Portugal | 2,194 | | 10,795 | | | – | | 403 | – | 10 | 13,402 |
| Sweden | 2,079 | | 7,496 | 1,225 | | 102 | 6,307 | 7,886 | 23,039 | 4,125 | 52,260 |
| Switzerland and Liechtenstein | 328 | 377 | 853 | 2 | 479 | 462 | 678 | 12,383 | 17,497 | 2,195 | 35,253 |
| Total | 5,092 | 377 | 20,697 | 1,226 | 479 | 611 | 12,136 | 127,415 | 55,306 | 54,106 | 277,446 |
| Percentage of total exports | | | | | | | | | | | 1.9% |
| **OTHER WESTERN EUROPE** | | | | | | | | | | | |
| Greece | 7,697 | | 6,835 | | | 13 | 352 | 3,660 | 449 | 60,537 | 79,543 |
| Spain | 9,285 | | 102,332 | 9,094 | | 96 | 191 | 2,194 | 1,270 | 184 | 124,635 |
| Turkey | 2,419 | | 16,653 | | | 44 | 300 | 446 | 16 | 27 | 19,905 |
| Yugoslavia | 1,659 | | 16,560 | | | | 438 | 1,030 | 1,522 | 8,124 | 29,331 |
| Others | 414 | 5 | 144 | | | – | 1,350 | 4,007 | 238 | 1,239 | 7,397 |
| Total | 21,473 | 5 | 142,524 | 9,094 | | 154 | 2,630 | 11,336 | 3,495 | 70,111 | 260,811 |
| Percentage of total exports | | | | | | | | | | | 1.8% |
| **EASTERN EUROPE** | | | | | | | | | | | |
| Albania | | | | | | | | 3 | | 108 | 111 |
| Bulgaria | 159 | | 3,255 | | | | | 60 | 20 | 2,901 | 6,395 |
| Czechoslovakia | | | 5,514 | | | 30 | – | | – | 1,180 | 6,725 |
| German Dem. Rep. | 1 | | 7,100 | | | | | | | 13 | 7,114 |
| Hungary | 449 | | 594 | | | 125 | 1 | – | 1,355 | 1,200 | 3,723 |
| Poland | 1,261 | | 26,280 | | | 41 | 5,489 | 47 | 89 | 16,707 | 49,914 |
| Romania | | | 15,220 | | | | 117 | | – | 3,105 | 18,442 |
| U.S.S.R. | | | 84,235 | 1 | 11,905 | 80 | 70 | 1,462 | 1,721 | 36,137 | 135,610 |
| Total | 1,870 | | 142,197 | 1 | 11,905 | 275 | 5,677 | 1,573 | 3,186 | 61,351 | 228,034 |
| Percentage of total exports | | | | | | | | | | | 1.5% |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

**[continued]**

# TABLE V (continued)

| Country of destination | Food | Beverages & tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **SOUTH EAST ASIA** | | | | | | | | | | | |
| Brunei | 33,989 | 8,117 | 3,069 | 25,083 | 259 | 14,895 | 50,732 | 59,887 | 17,993 | 4,507 | 218,530 |
| Burma | 733 | 348 | 49 | 9,824 | 14,501 | 2,103 | 2,245 | 24,462 | 578 | 522 | 55,364 |
| Cambodia | | | | 402 | | 75 | 12 | 143 | | | 631 |
| Laos | – | 11 | | 11,099 | | 107 | 358 | 4 | 44 | 2 | 11,624 |
| Malaysia (Peninsular) | 205,231 | 5,298 | 93,136 | 250,497 | 4,616 | 181,362 | 237,583 | 507,335 | 75,178 | 33,705 | 1,593,942 |
| Philippines | 2,425 | 134 | 4,048 | 102,710 | 100 | 15,308 | 12,554 | 67,268 | 3,316 | 7,695 | 215,559 |
| Indonesia | 4,411 | 1,858 | | | | 360 | 205 | 22 | 236 | | 7,091 |
| Sabah (East Malaysia) | 48,995 | 2,884 | 4,697 | 39,811 | 839 | 14,737 | 43,905 | 77,989 | 23,980 | 7,414 | 265,252 |
| Sarawak (East Malaysia) | 51,306 | 1,445 | 4,178 | 26,710 | 407 | 17,184 | 37,933 | 82,988 | 12,368 | 3,998 | 238,517 |
| Thailand | 14,575 | 2,710 | 16,074 | 179,365 | 3,392 | 36,108 | 13,169 | 93,538 | 7,506 | 12,955 | 379,393 |
| Vietnam Socialist Rep. of | 161 | 8 | 513 | 27,354 | 2,430 | 3,385 | 11,272 | 1,343 | 72 | 120 | 46,658 |
| Total | 361,827 | 22,812 | 125,765 | 672,856 | 26,544 | 285,624 | 409,968 | 914,978 | 141,270 | 70,917 | 3,032,561 |
| Percentage of total exports | | | | | | | | | | | 20.4% |
| **NORTH EAST ASIA** | | | | | | | | | | | |
| China | 5,234 | 1 | 55,006 | 2 | | 467 | 2,042 | 33,121 | 9 | 18,124 | 114,005 |
| Hongkong | 34,494 | 3,817 | 25,587 | 713,800 | 6,693 | 31,343 | 61,189 | 133,452 | 65,661 | 22,191 | 1,098,227 |
| Japan | 79,251 | 1,261 | 56,931 | 880,067 | 37,983 | 77,712 | 25,613 | 99,898 | 34,566 | 83,386 | 1,376,669 |
| Korea (North) | | 35 | 608 | 2 | 1,613 | 14,766 | 2,711 | 353 | | 790 | 20,878 |
| Korea (South) | 6,265 | 23 | 139,612 | 54,935 | 1,075 | 1,497 | 3,859 | 23,082 | 360 | 8,836 | 239,544 |
| Macau | | | | | | | | | 34 | 56 | 90 |
| Mongolia | | | 157 | | | | | | 2 | | 159 |
| Taiwan | 17,802 | 321 | 53,112 | 51,727 | 976 | 12,550 | 11,323 | 32,109 | 4,875 | 14,288 | 199,084 |
| Total | 143,046 | 5,458 | 331,013 | 1,700,532 | 48,341 | 138,335 | 106,736 | 322,015 | 105,507 | 147,671 | 3,048,655 |
| Percentage of total exports | | | | | | | | | | | 20.5% |
| **SOUTH ASIA** | | | | | | | | | | | |
| Afghanistan | 1,036 | | 766 | | | 782 | 1,427 | 671 | 22 | – | 4,705 |
| Bangladesh | 2,967 | 370 | 6,078 | 6,063 | 2,466 | 2,796 | 13,598 | 19,492 | 550 | 560 | 54,940 |
| Christmas Is. | 629 | 93 | 33 | 264 | 54 | 62 | 2,025 | 2,970 | 458 | 533 | 7,121 |
| India | 7,834 | 465 | 13,433 | 1,765 | 82,895 | 7,002 | 6,046 | 25,899 | 2,460 | 38,798 | 186,598 |
| Nepal | 346 | 34 | 1 | 98 | 75 | 649 | 835 | 825 | 152 | 14 | 3,028 |
| Pakistan | 10,494 | 177 | 19,086 | 214 | 3,696 | 11,607 | 6,172 | 10,057 | 995 | 3,333 | 65,830 |
| Sri Lanka | 17,752 | 202 | 354 | 6,604 | 664 | 2,592 | 32,767 | 6,415 | 657 | 936 | 68,942 |
| Others | 1,465 | 196 | 48 | 428 | 4 | 236 | 2,838 | 1,522 | 734 | 594 | 8,067 |
| Total | 42,522 | 1,537 | 39,797 | 15,437 | 89,853 | 25,727 | 65,709 | 67,851 | 6,028 | 44,768 | 399,230 |
| Percentage of total exports | | | | | | | | | | | 2.7% |
| **WEST ASIA** | | | | | | | | | | | |
| Aden | 3,515 | | 6,740 | | 4,420 | 1,296 | 2,508 | 207 | 941 | 12 | 19,639 |
| Bahrein | 2,151 | 4,264 | 4,156 | 4,062 | 828 | 1,199 | 10,808 | 17,606 | 4,732 | 1,062 | 50,868 |
| Cyprus | 188 | | 753 | | 97 | | 1,648 | 4,932 | 74 | 2,612 | 10,305 |
| Iran | 1,910 | 62 | 23,602 | 1 | 1,617 | 8,542 | 7,176 | 12,721 | 2,600 | 1,135 | 59,365 |
| Iraq | 322 | 61 | 4,270 | | 7,907 | 4 | 3,635 | 5,586 | 617 | 691 | 23,092 |
| Israel | 6,678 | | 14,802 | | 4,771 | 71 | 1,676 | 4,115 | 137 | 465 | 32,715 |
| Jordan | 5,181 | 4 | 330 | 3,962 | 40 | 80 | 458 | 2,413 | 289 | 5 | 12,764 |
| Kuwait | 4,895 | 1,895 | 959 | 9,205 | 389 | 3,668 | 8,503 | 17,360 | 16,884 | 948 | 64,706 |
| Lebanon | 289 | | 116 | | 147 | 6 | 213 | 582 | 169 | 750 | 2,272 |
| Saudi Arabia | 23,665 | 702 | 22,205 | 25,393 | 38,114 | 6,400 | 27,995 | 37,181 | 25,861 | 2,387 | 209,904 |
| Syria | 813 | | 853 | | 1,280 | 69 | – | 1,007 | 221 | 3 | 4,246 |
| United Arab Emirates | 20,698 | 8,538 | 14,887 | 78,802 | 2,190 | 5,749 | 35,008 | 28,318 | 17,381 | 1,301 | 212,873 |
| Others | 19,234 | 1,743 | 26,592 | 2,304 | 1,764 | 4,653 | 11,467 | 24,916 | 6,133 | 125 | 98,932 |
| Total | 89,541 | 17,269 | 120,266 | 123,730 | 63,563 | 31,736 | 111,095 | 156,945 | 76,039 | 11,496 | 801,680 |
| Percentage total of exports | | | | | | | | | | | 5.4% |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

**[continued]**

## TABLE V (continued)

| Country of Destination | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **NORTH AFRICA** | | | | | | | | | | | |
| Algeria | 7,545 | | 3,716 | — | | 24 | 13,123 | 7,277 | 63 | 771 | 32,519 |
| Egypt | 2,640 | | 7,345 | 2,225 | 5,865 | 73 | 3,110 | 5,747 | 602 | 252 | 27,859 |
| Libya | 1,051 | | 759 | | 100 | 435 | 96 | 1,908 | 2,208 | 61 | 6,621 |
| Morocco | 4,576 | | 2,291 | | 58 | 26 | 6 | 1,087 | 56 | 23 | 8,122 |
| Sudan | 531 | | 1,290 | 4,006 | 125 | 3,802 | 1,947 | 1,666 | 57 | 17 | 13,442 |
| Tunisia | 3,471 | | 28 | | | | | 30 | 65 | 101 | 3,695 |
| Others | 3,799 | | 1,904 | 4,227 | 13,258 | 695 | 5,716 | 2,891 | 514 | 228 | 33,231 |
| Total | 23,612 | | 17,333 | 10,459 | 19,407 | 5,055 | 23,999 | 20,607 | 3,566 | 1,452 | 125,490 |
| Percentage of total exports | | | | | | | | | | | 0.8% |
| **OTHER AFRICA** | | | | | | | | | | | |
| Angola | | | 369 | | 1,875 | 222 | | 423 | | | 2,889 |
| Ghana | 5 | | 17 | | | 863 | 88 | 920 | 21,156 | 38 | 23,088 |
| Ivory Coast | | | | | | 12 | 374 | 3,145 | 93 | 50 | 3,674 |
| Kenya | 166 | 2 | 3,948 | 6,032 | 2,532 | 2,041 | 1,959 | 1,809 | 1,280 | 77 | 19,845 |
| Liberia | 11 | | | | | 702 | 442 | 58,953 | 241 | 116,465 | 176,815 |
| Malagasy Rep. | 1 | 4 | | 989 | 783 | 65 | 3,513 | 4 | 117 | 95 | 5,571 |
| Mauritius | 1,317 | 22 | 906 | 756 | 873 | 844 | 7,653 | 1,023 | 1,258 | 25 | 14,677 |
| Mozambique | 690 | | 903 | 60 | | 211 | 827 | 339 | 54 | 31 | 3,115 |
| Nigeria | 112 | | 286 | | 2 | 2,694 | 15,982 | 17,552 | 6,690 | 801 | 44,119 |
| Reunion Island | 4,783 | 7 | 3,598 | 3,191 | 15 | 33 | 4,214 | 678 | 1,082 | | 17,601 |
| Tanzania | 279 | 15 | 4,783 | 1,707 | 5,380 | 822 | 1,746 | 2,601 | 117 | 580 | 18,029 |
| Uganda | | | 1 | | | 500 | 24 | 24 | 2 | 2 | 553 |
| Zambia | 1 | | 1,943 | 2,519 | | 594 | 173 | 607 | 101 | 10 | 5,949 |
| Others | 35,455 | 19 | 72,972 | 31,700 | 2,206 | 5,176 | 9,651 | 22,506 | 4,668 | 1,332 | 185,686 |
| Total | 42,821 | 69 | 89,727 | 46,954 | 13,665 | 14,780 | 46,646 | 110,584 | 36,859 | 119,505 | 521,611 |
| Percentage of total exports | | | | | | | | | | | 3.5% |
| **NORTH AMERICA** | | | | | | | | | | | |
| Canada | 9,067 | 5 | 80,595 | — | 1 | 375 | 8,977 | 51,700 | 16,185 | 1,563 | 168,467 |
| U.S.A. | 143,939 | 52 | 353,197 | 323,825 | 54,624 | 5,944 | 95,189 | 1,095,534 | 209,676 | 73,299 | 2,355,278 |
| Total | 153,005 | 57 | 433,793 | 323,825 | 54,624 | 6,319 | 104,166 | 1,147,234 | 225,861 | 74,862 | 2,523,746 |
| Percentage of total exports | | | | | | | | | | | 16.9% |
| **L.A.F.T.A.** | | | | | | | | | | | |
| Argentine | 448 | | 30,295 | | | 45 | 179 | 467 | 552 | 336 | 32,321 |
| Brazil | 792 | | 80,515 | | | 1 | 24 | 408 | 1,341 | 4,377 | 87,457 |
| Chile | 306 | | 9,846 | 132 | 4 | | 49 | 926 | 94 | 40 | 11,398 |
| Colombia | 236 | 3 | 15,163 | | | — | 1,054 | 5,414 | 6 | 5 | 21,882 |
| Ecuador | 90 | | 1,801 | 581 | | | | 126 | — | | 2,598 |
| Mexico | 27 | | 42,096 | | | | 17 | 121 | 200 | 7 | 42,467 |
| Paraguay | 1,020 | | 88 | | | | | 73 | | | 1,181 |
| Peru | 642 | | 10,530 | | 413 | | 82 | 334 | 54 | 4 | 12,059 |
| Uruguay | 71 | | 4,604 | | | | 7 | 184 | 6 | | 4,872 |
| Venezuela | 2,282 | | 10,930 | 506 | | 8 | 13 | 2,191 | 1,064 | 27 | 17,021 |
| Total | 5,914 | 3 | 205,867 | 1,220 | 417 | 54 | 1,425 | 10,244 | 3,315 | 4,796 | 233,254 |
| Percentage of total exports | | | | | | | | | | | 1.6% |
| **OTHER CENTRAL & SOUTH AMERICA** | | | | | | | | | | | |
| Cuba | | | 1,317 | | | | | | 162 | 215 | 1,695 |
| Dominican Republic | 623 | | 1,036 | | | | — | 29 | 6 | | 1,694 |
| Netherlands Antilles | | | | 10,664 | | | 125 | 189 | 96 | 120 | 11,194 |
| Panama | 62 | | | | | | 267 | 53,548 | 279 | 106,193 | 160,350 |
| Others | 2,506 | | 1,780 | | | 273 | 1,455 | 5,908 | 1,601 | 3,887 | 17,410 |
| Total | 3,191 | | 4,134 | 10,664 | | 273 | 1,847 | 59,673 | 2,144 | 110,416 | 192,344 |
| Percentage of total exports | | | | | | | | | | | 1.3% |

*Note:* Figures may not add up to the totals due to rounding value less than S$500.

*Source:* Singapore Economic Bulletin, January 1978 (slightly revised).

**[continued]**

## TABLE V (continued)

| Country of Destination | Food | Beverages & Tobacco | Crude Material | Mineral Fuels | Animal & Vegetable oils & fats | Chemicals | Manufactured Goods by Material | Machinery & Transport | Misc. Manufactured Articles | Misc. Transactions | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **OCEANIA** | | | | | | | | | | | |
| Australia | 34,505 | 38 | 59,436 | 355,764 | 5,746 | 7,931 | 34,145 | 124,323 | 36,963 | 61,285 | 720,136 |
| Fiji | 1,430 | | 64 | 58,212 | 431 | 564 | 5,255 | 1,428 | 4,009 | 65 | 71,458 |
| New Caledonia | 52 | | 163 | 46,840 | | 1 | 1,160 | 490 | 996 | 30 | 49,731 |
| New Zealand | 11,451 | 15 | 13,412 | 101,322 | 328 | 831 | 12,455 | 16,206 | 2,692 | 4,146 | 162,858 |
| Papua New Guinea | 278 | 3 | 260 | 75,610 | 342 | 266 | 6,252 | 1,530 | 7,631 | 91 | 92,263 |
| Western Samoa | 6 | 34 | | | | 2 | 319 | 1 | 285 | | 647 |
| Others | 184 | 48 | 36 | 56,038 | 10 | 43 | 2,739 | 386 | 2,199 | 198 | 61,881 |
| Total | 47,905 | 138 | 73,370 | 693,786 | 6,857 | 9,639 | 62,324 | 144,365 | 54,775 | 65,815 | 1,158,975 |
| Percentage of total exports | | | | | | | | | | | 7.8% |
| TOTAL | 1,040,721 | 47,925 | 2,330,647 | 3,617,356 | 359,756 | 533,199 | 1,102,754 | 3,707,637 | 1,006,197 | 1,116,474 | 14,862,666 |

***Note:*** Figures may not add up to the totals due to rounding value less than S$500.

***Source:*** Singapore Economic Bulletin, January 1978 (slightly revised).

## Cumulative Index 1978 - Nos. 1, 2 & 3

# NEUERSCHEINUNGEN

**Arnold-Bergstraesser-Institut, Freiburg i. Br.**
**MATERIALIEN ZU ENTWICKLUNG UND POLITIK**

D. Lerche — Nr. 15

**Steuerpotential und Steuerpraxis in Entwicklungsländern**

344 S., DM 44.–/ISBN 3 8039 0156 1

Im Mittelpunkt der Studie steht die Diskrepanz zwischen Soll und Ist der Besteuerung. Ausgehend von dem wirtschaftlich und steuergesetzlich begründeten Steuerpotential konzentriert sich die Analyse — entgegen dem üblichen formaljuristischen Ansatz — auf die Steuerwirklichkeit, d.h. auf Ursachen, Größenordnungen und Auswirkungen der Lücken zwischen Steuergesetzen und Steuerpraxis. In der theoretischen Einführung wird eine Systematik der Besteuerung mit den drei Kernvariablen Steuerverwaltung, Steuergesetzgebung und Steuerpflichtiger entwickelt. Die Fallstudie im Hauptteil liefert umfangreiches Material über Entstehung und Messung des Steuerpotentials, der Steuermentalität und Steuerverwaltung sowie über die fiskal-wirtschafts- und sozialpolitische Effizienz des Steuersystems in Indonesien.

M. Fremerey — Nr. 17

**Studenten und Politik in Indonesien**

220 S., DM 34.–/ISBN 3 8039 0156 1

Dieses Buch diskutiert die Frage, ob und unter welchen Voraussetzungen die indonesische Studentenschaft den Anspruch eines politischen Korrektivs erfüllen kann. Gestützt auf eine Anfang der 70er Jahre durchgeführte Befragung gilt dabei das Hauptaugenmerk den politischen Einstellungen unter den Studenten und deren sozio-demographischen Einflußfaktoren. Analysen der politischen und universitären Rahmenbedingungen sowie der jüngsten Studentenbewegungen in Indonesien erweitern den Untersuchungsrahmen. Die in vielen Arbeiten hervorgehobene Bedeutung der Studenten im politischen Prozeß — sei es in Indonesien oder in anderen Ländern der Dritten Welt, — machen das Fazit der vorliegenden Studie besonders beachtenswert.

**WELTFORUM VERLAG · TINTORETTOSTRASSE 1 · D-8000 MÜNCHEN 19**

# JAPAN: The Tax Committee Recommends A Large Scale Tax Increase

by Makoto Miura*

## I. THE RECOMMENDATIONS OF THE TAX COMMITTEE: AN OUTLINE AND SOME BACKGROUND INFORMATION

On October 4, 1977 the Tax Committee, headed by Mr. Takekazu Ogura, submitted a plan for a major tax reform to Prime Minister T. Fukuda. The main feature of this plan is a large scale tax increase which would be effected by (i) an increase in all existing tax rates and (ii) the introduction of new tax, i.e. the so-called General Consumption Tax, (GCT).

The reasons given by the Tax Committee for proposing such a drastic increase in the level of taxation are the following:

1. The Government has come to depend more and more on loans to balance its Budget. In fact, none of the other developed countries relies so heavily on debt financing as does Japan. For instance, in 1977 bond issues accounted for 30 percent of the Central Government's revenue. This ratio was 29.9 percent in 1976 and 25.3 percent in 1975, whereas the average ratio from 1970-74 was only 11.2 percent. A similar situation exists at the local level, since local authorities have also been heavily dependent in recent years on local bond issues and other loans.
2. The huge deficits shown by the national and local budgets are not only caused by the recent economic depression but also by a fundamental financial imbalance between current expenditure and current revenue. Therefore. even if the present economic depression came to an end and another boom period set in these large budgetary deficits would not disappear. In addition, many Japanese economic experts think that Japan's past rapid economic growth has definitively ended, so that it cannot be expected that the steady increase in tax revenue seen in the past will continue.
3. A possible way to reduce the budgetary deficits is to curb increases in financial expenditure. However, this will most certainly be difficult as a result of both domestic and international demands. With respect to the latter, the Japanese Government has to take into account that many of the major advanced industrial countries are opposed to a further increase in Japanese exports and instead urge the Japanese Government to allow more imports to meet the increasing domestic needs of the Japanese population.
4. Accordingly, there is only one way left for reducing

**RATES ON INDIVIDUAL INCOME TAX**

| Taxable Income (A) Over | But not over | Tax Rate (B) | Cumulative Tax for Each Bracket (C) |
|---|---|---|---|
| – | 600,000 yen | 10% | – |
| 600,000 yen | 1,200,000 | 12% | 60,000 yen |
| 1,200,000 | 1,800,000 | 14% | 132,000 |
| 1,800,000 | 2,400,000 | 16% | 216,000 |
| 2,400,000 | 3,000,000 | 18% | 312,000 |
| 3,000,000 | 4,000,000 | 21% | 420,000 |
| 4,000,000 | 5,000,000 | 24% | 630,000 |
| 5,000,000 | 6,000,000 | 27% | 870,000 |
| 6,000,000 | 7,000,000 | 30% | 1,140,000 |
| 7,000,000 | 8,000,000 | 34% | 1,440,000 |
| 8,000,000 | 10,000,000 | 38% | 1,780,000 |
| 10,000,000 | 12,000,000 | 42% | 2,540,000 |
| 12,000,000 | 15,000,000 | 46% | 3,380,000 |
| 15,000,000 | 20,000,000 | 50% | 4,760,000 |
| 20,000,000 | 30,000,000 | 55% | 7,260,000 |
| 30,000,000 | 40,000,000 | 60% | 12,760,000 |
| 40,000,000 | 60,000,000 | 65% | 18,760,000 |
| 60,000,000 | 80,000,000 | 70% | 31,760,000 |
| 80,000,000 | | 75% | 45,760,000 |

*Note: Tax liability is obtained by multiplying the taxable income in excess of the amount (A) by the rate (B) and adding the amount (C). For example, income tax due on taxable income of 25 million yen is:*

(¥25,000,000 – ¥20,000,000 (A)) X 0.55 (B) + ¥7,260,000 (C) = ¥10,010,000

Including local taxes these rates run from 14% to 93%.

* Director of the Institute of Tax & Management.

SOME HIGHLIGHTS OF JAPANESE TAXATION *

The present taxes of Japan imposed by national and local governments can be classified into four groups; i.e., taxes on income, on property, on consumption and on transfer of goods:

1. **Taxes on Income:**

| | |
|---|---|
| National Taxes | Income Tax (individual Income Tax) and Corporation Tax (Corporate Income Tax); |
| Local Taxes | Prefectural Inhabitants Tax, Enterprise Tax** and Municipal Inhabitants Tax; |

2. **Taxes on Property:**

| | |
|---|---|
| National Taxes | Inheritance Tax and Gift Tax; |
| Local Taxes | Automobile Tax, Mine-lot Tax, Property Tax, Light Vehicle Tax, Special Landholding Tax, Business Office Tax*** and City Planning Tax; |

3. **Taxes on Consumption:**

| | |
|---|---|
| National Taxes | Liquor Tax, Sugar Excise Tax, Gasoline Tax, Liquefied Petroleum Gas Tax, Aviation Fuel Tax, Commodity Tax, Playing-cards Tax, Travel Tax, Admission Tax, Local Road Tax, Customs Duty and Monopoly Profits; 1 |
| Local Taxes | Prefectural Tobacco Consumption Tax, Local Entertainment Tax, Tax on Consumption at Hotels and Restaurants, Light-oil Delivery Tax, Municipal Tobacco Consumption Tax, Electricity Tax, Gas Tax and Bathing Tax; |

4. **Taxes on Transfer of Goods:**

| | |
|---|---|
| National Taxes | Bourse Tax, Securities Transaction Tax, Registration and License Tax, Motor Vehicle Tonnage Tax, Stamp Tax, Tonnage Due, Special Tonnage Due and Promotion of Power-Resources Development Tax; |
| Local Taxes | Real Property Acquisition Tax, Hunters License Tax, Automobile Acquisition Tax, Timber Delivery Tax, Hunting Tax and Mineral Product Tax; |

* *Source:* An Outline of Japanese Taxes 1977; published by the Tax Bureau of the Ministry of Finance, at 13.
** Strictly speaking, the Enterprise Tax cannot be classified as a tax on income. With respect to certain types of business, the Enterprise Tax is now imposed on gross proceeds instead of income. The Enterprise Tax and its predecessor, the Business Tax, historically have been imposed on the external forms of business, such as the amount of capital, the number of employees, gross proceeds, etc.
*** "Business Office Tax" is a provisional translation of "*Jigyosho-zei*".
1. *Author's note:* In 1978 also a Crude Oil Tax on Domestic Products and Imports was introduced.

the huge budgetary deficits and that is to increase tax revenue drastically. The Japanese Government has always stated that the ratio of the tax burden to national income in Japan is lower than in any other industrially advanced country, which is indeed true. In Japan, this ratio is, for instance, substantially lower than in Italy and one-half to two-thirds of the equivalent ratio in other EC countries. [1] It seems, therefore, that a proposal for a tax increase in Japan is reasonable.

Turning to the means of implementing such a large tax increase, the Tax Commission first recommends that inequities in the existing tax system be removed in order to resolve the complaints of Japanese taxpayers and obtain their cooperation. It then proceeds to outline the available means of raising additional tax revenue.

(1) In the Tax Commission's opinion it is possible to raise the rates of the Individual Income Tax (including the Local Individual Income Tax). However, since its rates are already very high for those taxpayers who fall in the high income tax brackets (the top marginal rate is 93 percent), low and middle income taxpayers could not escape a substantial increase in their tax bills.

(2) The rates of the Corporate Income Tax (including local tax) could be slightly raised, since its maximum effective rate of 49.47 percent is somewhat lower than the corresponding rates of corporate income tax in France (50 percent), Germany (56 percent), the United Kingdom (52 percent) and the United States (Federal and State income taxes are generally over 50 percent).

(3) It would also be feasible to increase other taxes such as the Inheritance Tax, Property Tax and several excise taxes since the burden of these taxes is generally lower than is the case in other advanced industrial countries.

However, it is certain that increasing the Individual or Corporate Income Tax would meet strong opposition from taxpayers, whereas increasing the taxes indicated in (3) above would not yield sufficient revenue to solve the problem at hand.

The Tax Commission's conclusion is, therefore, that it is not possible to substantially reduce the budgetary deficits by merely increasing the rates of existing taxes. For the Japanese Government there seems to be only one possible solution and that is to introduce a new tax in the form of a general consumption tax which would be able to generate a large amount of revenue. This tax is discussed in the following section.

## II. THE JAPANESE STYLE GENERAL CONSUMPTION TAX

The General Consumption Tax (GCT) would constitute an entirely new kind of tax in the present Japanese tax

1. See The O.E.C.D. Report on Government Revenue Statistics in *Bulletin*, July 1977 at 324.

system. Its main features as proposed by the Tax Committee are as follows.

GCT would be imposed on all goods and services at all stages of production and distribution in Japan. In other words, the GCT would be payable by all entrepreneurs who deliver goods, render services or import goods into Japan. The Tax Committee indicates that two types of GCT would be possible. Type 1 would be levied at a comparatively low rate on the sales prices of goods and services, whereas Type 2 would be imposed on the *difference* between the sales price and the entrepreneur's purchase price. Therefore, the former is a multistage (cascade) turnover tax and the latter resembles to a certain extent the VAT (Value Added Tax) as currently levied in the EC countries. The Tax Committee advocates the exemption of basic necessities (e.g. food) from the tax and also the exemption of exports.

In addition, small businesses would fall outside the scope of the GCT.

However, the Tax Committee only sketches out the broad outlines of the turnover tax it recommends and does not provide any details. Although it is likely that the Japanese Government will adopt some type of GCT there is not yet any official indication as to the type which will be selected, whether small businesses will be brought under the tax, the range of the tax rates, how much revenue the tax is expected to yield and when the tax will be enacted.
It is generally presumed that the Tax Bureau of the Ministry of Finance has worked out some kind of plan with respect to the GCT, but no official announcements have been made. However, there have been some unofficial discussions and sufficient information has been leaked to the public so that the following picture emerges:

(i) It is very probable that the Japanese Government will propose the introduction of some kind of VAT type of general consumption tax, since the introduction of a Type 1 turnover tax in 1949 met with complete failure.

(ii) The amount of tax revenue which the Government expects to generate will be in the neighborhood of five to six trillion yen (i.e. about 20 to 24 billion US$). If the GCT were introduced in April 1978 — i.e. for the 1978 fiscal year — it would account for about 20 percent of national tax revenue. In order to produce this level of revenue, the rate of the GCT would have to be (of course depending on the importance of the exemptions) 8 to 10 percent if the VAT type were selected and 2 to 2.5 percent if the Type 1 turnover tax were introduced.

(iii) The exemption for small businesses would depend on the importance of their sales (turnover) and the exemption limit would be determined by reference to the corresponding exemption which exists in the VAT legislation of the EC countries.

(iv) Similarly, exempted transactions would be determined by reference to the VAT legislation of the EC countries.

### RATES OF CORPORATE INCOME TAX

**a. Tax Rates for Ordinary Income Not Distributed as Dividends**

| | |
|---|---|
| 1. Ordinary corporations | |
| a) Corporations with capital of more than 100 million yen | 40% |
| b) Corporations with capital of not more than 100 million yen | |
| For annual income of more than 7 million yen | 40% |
| For annual income of not more than 7 million yen | 28% |
| 2. Cooperative associations and corporations in public interest | 23% |

**b. Reduced Rates Applicable to Ordinary Income Distributed as Dividends**

| | |
|---|---|
| 1. Ordinary corporations | |
| a) Corporations with capital of more than 100 million yen | 30% |
| b) Corporations with capital of not more than 100 million yen | |
| For annual income of more than 7 million yen | 30% |
| For annual income of not more than 7 million yen | 22% |
| 2. Cooperative associations | 19% |

Reduced rates are applicable to the amounts distributed as dividends in excess of dividends, if any, received from domestic corporations.

The average rate of taxes on corporate income is usually assumed to be 39.47%, which is computed as follows:

| | |
|---|---|
| Corporate Income Tax (assuming that 30% of income before tax is distributed as dividend) | 33.04% |
| Prefectural Inhabitant Tax | 1.72% |
| Municipal Inhabitant Tax | 4.00% |
| Enterprise Tax, its stated rate is 12% but since it is a deductible tax its effective rate is | 10.71% |
| Total | 49.47% |

The VAT as proposed by the Tax Committee is sometimes called "VAT Japanese style". One of the major differences between this type of VAT and the VAT which is currently used in the EC countries is that under the Japanese version the procedure is simpler, i.e. the taxpayer does not need to compute the tax which has previously been invoiced to him. A corollary of the Japanese VAT system is that the taxpayer (entrepreneur) does not have to disclose the tax which was previously paid by him. In other words, his customer — whether the purchaser of goods delivered by the entrepreneur or the client to whom he has rendered a service — will not be able to ascertain the amount of VAT included in the sales price and which is passed on to the

# REVENUE ESTIMATES 1977 - 78+

(In billions of yen)

**National Taxes**

| | 1977 Provisional | | 1977 Ultimate | | 1978 Provisional | |
|---|---|---|---|---|---|---|
| Tax item | Amount | % | Amount | % | Amount | % |
| I. General Account | | | | | | |
| Direct Taxes | | | | | | |
| Income Tax | 7,348 | 38.0 | 7,048 | 37.0 | 8,097 | 35.6 |
| Corporation Tax | 5,813 | 30.1 | 5,813 | 30.5 | 7,262 | 32.0 |
| Inheritance Tax and Gift Tax | 366 | 1.9 | 366 | 1.9 | 366 | 1.6 |
| Indirect Taxes, etc. | | | | | | |
| Liquor Tax | 1,058 | 5.5 | 1,058 | 5.6 | 1,416 | 6.2 |
| Sugar Excise Tax | 45 | 0.2 | 45 | 0.2 | 55 | 0.2 |
| Gasoline Tax | 1,119 | 5.8 | 1,119 | 5.8 | 1,283 | 5.6 |
| Liquefied Petroleum Gas Tax | 15 | 0.1 | 15 | 0.1 | 16 | 0.1 |
| Aviation Fuel Tax | 19 | 0.1 | 19 | 0.1 | 22 | 0.1 |
| Crude Oil Tax | — | — | — | — | 162 | 0.7 |
| Commodity Tax | 777 | 4.0 | 777 | 4.1 | 916 | 4.0 |
| Playing-cards Tax | 1 | 0.0 | 1 | 0.0 | 1 | 0.0 |
| Bourse Tax | 10 | 0.1 | 10 | 0.1 | 13 | 0.1 |
| Securities Transaction Tax | 77 | 0.4 | 77 | 0.4 | 115 | 0.5 |
| Travel Tax | 50 | 0.3 | 50 | 0.3 | 51 | 0.2 |
| Admission Tax | 4 | 0.0 | 4 | 0.0 | 4 | 0.0 |
| Motor Vehicle Tonnage Tax | 289 | 1.5 | 289 | 1.5 | 326 | 1.4 |
| Customs Duty | 527 | 2.7 | 527 | 2.7 | 538 | 2.4 |
| Tonnage Due | 8 | 0.0 | 8 | 0.0 | 8 | 0.0 |
| Stamp Revenue | 714 | 3.7 | 714 | 2.8 | 799 | 3.5 |
| Monopoly Profits | 549 | 2.8 | 549 | 2.9 | 714 | 3.1 |
| II. Special Accounts | | | | | | |
| Local Road Tax* | 202 | 1.0 | 202 | 1.0 | 232 | 1.0 |
| Liquefied Petroleum Gas Tax* | 15 | 0.1 | 15 | 0.1 | 16 | 0.1 |
| Aviation Fuel Tax* | 3 | 0.0 | 3 | 0.0 | 4 | 0.0 |
| Motor Vehicle Tonnage Tax | 96 | 0.5 | 96 | 0.5 | 108 | 0.5 |
| Special Tonnage Duty* | 10 | 0.1 | 10 | 0.1 | 10 | 0.1 |
| Customs Duty on Oil | 184 | 0.9 | 184 | 0.9 | 159 | 0.7 |
| Promotion of Resources Development Tax | 33 | 0.2 | 33 | 0.2 | 36 | 0.2 |
| Total | 19,332 | 100.0 | 19.032 | 100.0 | 22,929 | 100.0 |

**Local Taxes**

| | 1977 Provisional | |
|---|---|---|
| Tax item | Amount | % |
| 1. Ordinary Taxes | | |
| (a) Prefectural Taxes | | |
| Prefectural Inhabitants Tax | 1,252 | 11.9 |
| Enterprise Tax | 2,006 | 19.1 |
| Real Property Acquisition Tax | 191 | 1.8 |
| Prefectural Tobacco Consumption Tax | 213 | 2.0 |
| Local Entertainment Tax | 66 | 0.6 |
| Tax on Consumption at Hotels and Restaurants | 304 | 2.9 |
| Automobile Tax | 520 | 5.0 |
| Mine-lot Tax | 1 | 0.0 |
| Hunters License Tax | 4 | 0.0 |
| Prefectural Property Tax | 5 | 0.0 |
| (b) Municipal Taxes | | |
| Municipal Inhabitants Tax | 2,476 | 23.6 |
| Municipal Property Tax** | 1,912 | 18.2 |
| Light Vehicle Tax | 35 | 0.3 |
| Municipal Tobacco Consumption Tax | 375 | 3.6 |
| Electricity Tax and Gas Tax | 202 | 1.9 |
| Mineral Product Tax | 3 | 0.0 |
| Timber Delivery Tax | 3 | 0.0 |
| Special Landholding Tax | 92 | 0.9 |
| 2. Other Ordinary Taxes not stipulated in the Local Tax Law | | |
| To, Do, Fu and Prefectures | 1 | 0.0 |
| Cities, Towns and Villages | 5 | 0.0 |
| 3. Earmarked Taxes | | |
| To, Do, Fu and Prefectures*** | 476 | 4.5 |
| Cities, Towns and Villages*** | 352 | 3.4 |
| Total | 10,492 | 100.0 |

+*Source:* An outline of Japanese Taxes 1917; published by the Tax Bureau of the Ministry of Finance, at 14, supplemented by Mr. Miura.

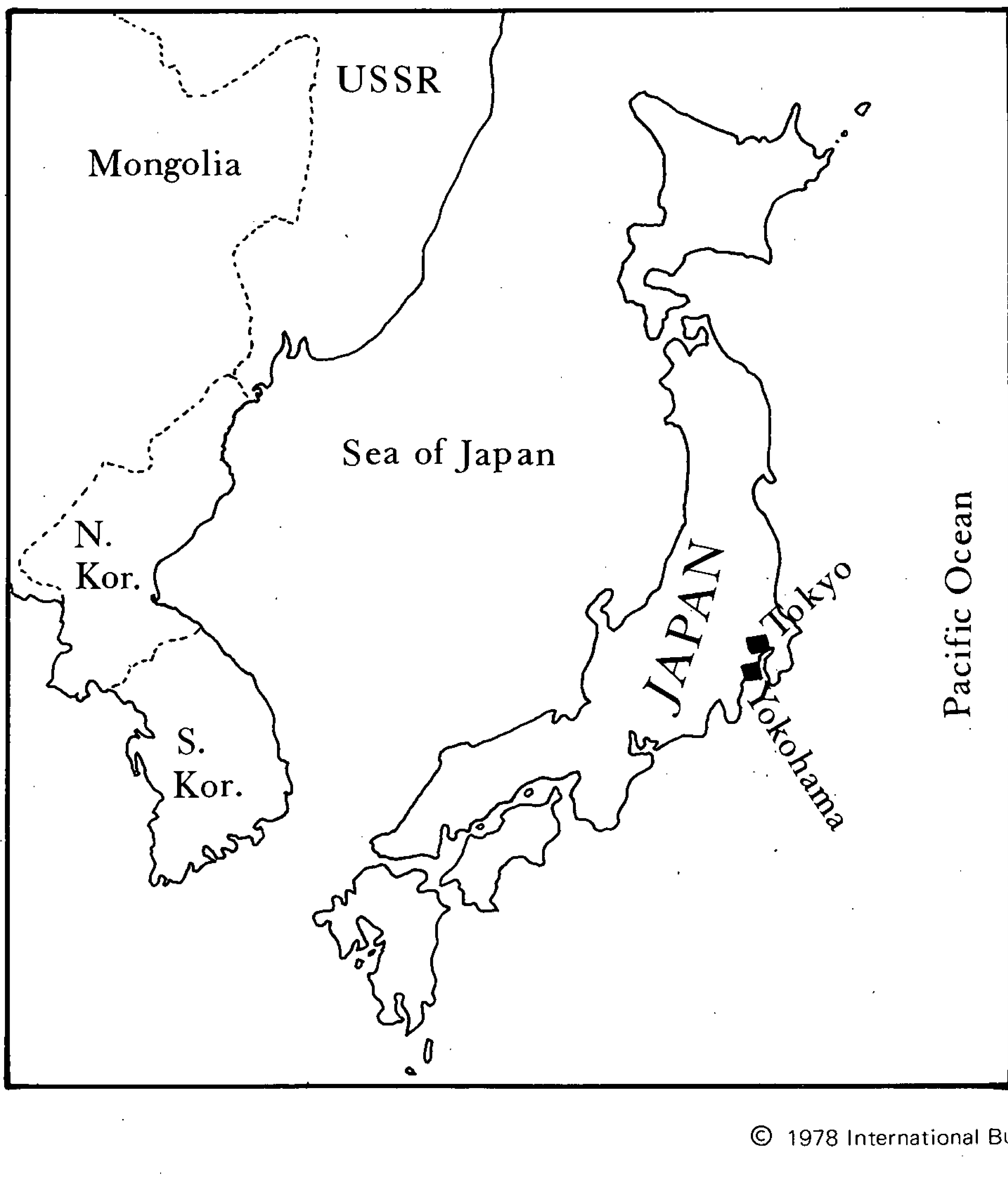
* Distributed to the local governments.
** Municipal property tax includes Charges on National Assets and Public Corporation's Assets.
*** Automobile acquisition tax, Light-oil Delivery Tax, etc., are included.
**** Bathing Tax, Business Office Tax, City Planning, etc., are included.

customer. This means that "VAT Japanese style" contains an element of inconvenience for the customer, a situation that could be reversed if the customer would request disclosure of the tax amount in writing (e.g. on the invoice) and because of market conditions the seller would have to acquiesce. In the latter case, however, the seller would have to disclose his added value, i.e. his gross profit, which would give away one of his commercial secrets.

However, the most difficult problem which the Government will have to face when introducing GCT is that the tax is very unpopular in Japan. The reasons for this unpopularity are twofold. First, the GCT will without any doubt raise the price of all goods and services and will thus impose a heavy burden on Japanese taxpayers, especially on those in the low to middle income classes. The second reason is that a GCT type of turnover tax does not seem to fit in well with the climate of Japanese life, and it is particulary unsuited for Japanese-style business activities. With respect to the latter, the structure of the Japanese distribution system is so complicated that even a GCT in the form of a VAT would have a cumulative effect. In addition, it is expected that Japanese entrepreneurs will strongly resist the introduction of the GCT. In the past it was only small and medium sized businesses which were opposed to the introduction of a VAT or GCT, but recently as a result of the economic depression more and more entrepreneurs have become reluctant to accept such a tax. In fact, the sentiment against the GCT and the movement to oppose its introduction are becoming quite strong.

The Cabinet of Prime Minister Fukuda decided to postpone the introduction of the GCT until after the 1978 fiscal year, and the nature of future developments is by no means clear. However, the Ministry of Finance has indicated its firm resolution to introduce the GCT in the future. As a proof of this resolution the Ministry of Finance — which means in fact the Cabinet — appointed two professors — Mr. Kazuo Kinoshita [2] and Mr. Sei Fujita, both of whom are known to be staunch advocates of a VAT or GCT, as new members of the Tax Commission.

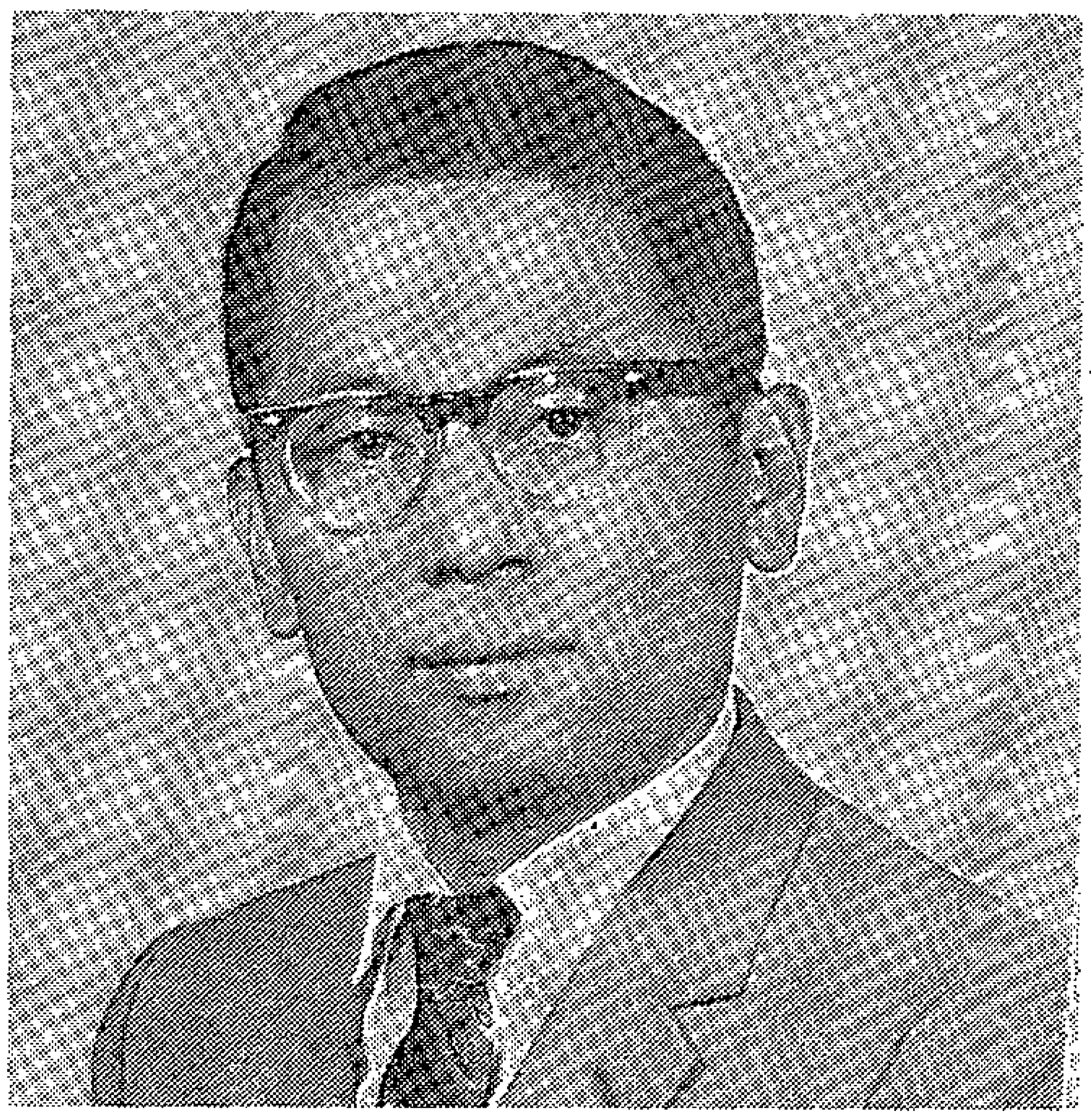
2. *Editor's Note:* Prof. Kinoshita is a member of the Bureau's Advisory Board.



# Fiscal Incentives for Japan's Export and Direct Foreign Investment

by Tomotaka Ishimine*

*Japan's direct foreign investment, which was inconspicuous during the 1960s, grew considerably during the early 1970s. By 1975, Japan's total outstanding direct foreign investment had reached $12.7 billion, which made her the fourth largest capital exporting nation after the United States ($118.6 billion), England ($32.6 billion) and West Germany ($15.3 billion), as shown in Table 1. This recent emergence of Japan as a major exporter of capital for direct foreign investment, together with her long-standing export surpluses in commodity trade, has generated an increasing interest among nations about possible fiscal incentives accorded by the Japanese government to corporations, such as tax concessions, subsidies and other forms of promotion. The objective of this study is to examine these fiscal incentives for Japan's exports in their broad spectrum, and examine how closely the incentives and the surge in Japanese direct foreign investment are related.*



## Corporate income tax

It can be said, at the outset, that until 1973 the main objective of Japanese tax policy was to stimulate economic growth. To accomplish this end, the proportion of corporate income tax in the total tax revenue was steadily lowered, beginning in 1952, until revenue from this source fell below the revenue from personal income tax in 1965. As of 1975, these two tax sources account for 34.6 percent and 37.2 percent respectively of total revenue. [1]

In reference to the corporate tax structure, although the nominal rate is substantially greater for larger firms, the difference is made considerably smaller in terms of the effective rate through various tax deductions and exemptions provided to larger firms to encourage their growth. [2] Beginning in 1952, the year of Japan's independence, the national total for corporate income *exempted or deducted* from taxable income increased from 97,030 million yen (approximately $270 million converted at the prevailing exchange rate) to 1,374,714 million yen (approximately $3,819 million) in 1963 — with the cumulative total over the twelve year period reaching 8,801 billion yen (approximately $24.5 billion). [3] Industry-wise, the exempted income ranged upward from 24.4 percent of total taxable income for small firms in the coal industry to 47.1 percent of taxable income for large firms in the iron and steel industries. [4]

The income exempted from taxable income included, among others, those portions of income generated in export earning (terminated in 1964), in producing "important products" such as electricity and machine tools, and the profit paid out as dividends for floating new shares. The deduction from taxable income included myriad items such as funds reserved for bad debts, price fluctuations, retirement payments, "special repayers",

*Department of Economics,
California State University, Long Beach, U.S.A.

1. Estimated from the data in Japan, Economic Planning Agency, *Keizai Hakusho, 1975* [1975 White Paper on the Economy] (Tokyo: Ministry of Finance Printing Office, 1976), p. 125. Revenue from indirect taxes, as opposed to the aforementioned direct taxes, comprises the rest, which is 28.2 percent. Japan also began to float bonds in 1964 for the first time in the postwar period, overcoming the anathema carried over since the end of WW II. The bond financing now comprises 29.7 percent of the total government budget of 1977. See *Keizai Hakusho, 1977*, pp. 110-122.
2. Estimated difference between larger firms and smaller firms in effective rates and in nominal rates (the latter in parentheses) for different countries is shown below. The figures indicate the difference in percentage points. Japan, 9.8 (12.9); the United States, 24.6 (26.0); England, 15.0 (15.0); West Germany, 23.4 (36.0); and France, 0 (0). The smaller figures indicate that the tax burden, though larger for larger firms in an absolute sense, is smaller for larger firms in a relative sense. Among other nations, only France treats larger firms more favorably than Japan. Estimated from the data in Ichiro Okuma, *Żaisei Tokuhon* [A Primer on Public Finance] (Tokyo: Toyo Keizai Shimo-sha, 1971), p. 83.
3. Estimated from the data provided in Kozo Yamamoto, *Economic Policy in Postwar Japan: Growth versus Economic Democracy* (Berkeley: University of California, 1967), p. 146. The Exchange rate used for conversion is 360 yen to a dollar, the rate prevailing at that time.
4. Ibid., p. 147.

export losses, "water shortages", "loss due to breach of contracts" and extraordinary risks".[5]

These exemptions and deductions followed the subsidies made available in the early postwar period in the form of low cost loans provided by the Bank of Japan under the program of the Keisha Seisan Hoshiki (roughly translated: the Unbalanced Growth Formula). Under this program, the industries considered strategically important to the postwar economic recovery were singled out for specific assistance. The industries in this category, namely, iron, coal, electricity and cement, had access to the Bank of Japan's low cost loans.

**TABLE 1**

**Direct foreign investment outstanding of selected countries and related ratios, 1974**

| Country | Amount (million dollars) | Against total DAC (%) | Against GNP (%) | Against exports (%) | Per capita investment (dollars) | Investment growth over 1967-74 (Annual average) |
|---|---|---|---|---|---|---|
| Japan | 12,664 | 5.6 | 2.8 | 27.8 | 115 | 31.4% |
| U.S. | 118,613 | 52.5 | 8.5 | 120.4 | 560 | 10.4 |
| England | 32,633 | 14.4 | 17.1 | 84.5 | 582 | 9.3 |
| W. Germany | 15,258 | 6.7 | 4.0 | 17.1 | 246 | 26.1 |
| France | 11,605 | 5.1 | 4.2 | 25.0 | 221 | 9.9 |
| Canada | 7,571 | 3.3 | 5.3 | 22.1 | 337 | 10.7 |
| DAC Members | 226,138 | 100.0 | 6.7 | 43.3 | 350 | 11.7 |

Source: Japan, MITI, *Tsusho Hakusho* (White Paper on International Trade).

## Export incentives

It should be reiterated that these loan subsidies, exemptions and deductions were a part of the policy to encourage the growth of the overall economy and were not specifically aimed at the export industries. However, there was one measure which specifically aimed at encouraging exports: a total exemption of export income from taxable income. This measure was terminated when Japan became a full-fledged member of the International Monetary Fund by accepting Article 8 of the IMF provisions, because the measure obviously contradicted other IMF provisions prohibiting export subsidy.

Aside from the loan subsidy, tax exemptions and tax deductions, the government has allowed, in the past as well as at present, the formation of cartels for selected industries for the purpose of quantitatively restricting and coordinating production, giving them various names such as recession cartels, rationalization cartels and administrative cartels. As of 1973, there were as many as 985 cartels.[6] Under these cartels, however, price fixing is specifically prohibited.

Formation of cartels for the purpose of restricting imports and exports was legalized by the 1955 amendment to the Export and Import Act. It is ironic that some of the export cartels, which were initially set up for coordinating and promoting exports, are assuming an added role in administering the so-called voluntary export restriction in order to mitigate frictions caused in the past by Japanese exports, such as textiles, steel, TV sets and automobiles.

In 1964 when the tax exemption for export income was terminated, new tax measures aimed at encouraging exports, as well as direct foreign investment, were introduced. These included:

(1) accelerated depreciation for enterprises deriving their income from overseas transactions;
(2) overseas market development reserves;
(3) overseas investment loss reserves;
(4) tax exemption for income from overseas technical transactions; and
(5) special expense accounts for export promotion.[7]

However, the measures for accelerated depreciation

5. For a partial list of exemptions and deductions, see K. Beida, *The Structure and Operation of the Japanese Economy* (Sydney: John Wiley, 1970), pp. 116-18.
6. Japan, Fair Trade Commission, *The Antimonopoly Act of Japan, Tokyo: 1973, p. 27.* For discussion of cartels, see Richard E. Caves and Masu Uekusa, *Industrial Organization in Japan* (Washington, D.C.: Brookings Institution, 1976), pp. 141-54.
7. Beida, op. cit. Also, for a brief account of this aspect, see Japan Trade Research Institute, ed., *Sengo Nihon no Boeki 20-nen-shi* [The Twenty Year History of Japanese Postwar Trade] (Tokyo: Research Institute for Trade and Industry, 1967), pp. 500-02.

(Item 1) and special expense accounts for export promotion (Item 5) have since been abolished.

To the remaining three measures, one more was added recently to protect investment in long term bonds denominated in foreign currency from possible exchange losses. Consequently, as of 1978, there are four broad categories of *short-run* tax measures shielding some portion of income from tax obligations for a period of five years. [8] Of these tax measures, one is aimed at promoting export, one pertains to technical transactions and the remaining two are concerned with direct foreign investment. Furthermore, the first measure aimed at export promotion and the third measure aimed at protecting firms from foreign exchange losses are to be phased out by the end of 1978. That will leave only two measures in existence after 1978, one pertaining to technical transactions and the other to direct foreign investment. The four measures still in effect as of 1978 are as follows.

## A. Incentives for Market Development and Technical Tranactions

### 1) *Overseas market development reserve for* medium and small firms

This measure allows firms with assets of 1 billion yen (approximately $4 million at the exchange rate of 250 yen to a dollar) or less to deduct an amount spent for overseas market development, not exceeding 0.85 percent for trading firms and 1.15 percent for manufacturing firms, from the total export earning of the previous year. For firms with assets of 100 million yen (approximately $400 thousand) or less, the permissible deductions are 1.7 and 2.3 percent for trading firms and manufacturing firms respectively. However, these reserves must be *added back* to the taxable income over *five years*, starting from the following year. This is a measure that is to be terminated in 1978. The purpose of providing an incentive for medium and small firms is to promote efficiency among them by exposing them to the vigor of international competition.

### 2) *Special deductions for income from overseas technical transactions*

Japan is in a net deficit position in its technical transactions. To encourage development of technology and improve its level through export of the same, the following deductions are allowed from taxable income: 55 percent of the amount involved in the transfer of industrial ownership, 20 percent for royalties, and 20 percent for income from technical services.

## B. Foreign investment incentives

The following two measures pertain to direct foreign investment.

### 1) *Special tax provision for long term securities denominated in foreign currency*

This allows firms to deduct the exchange loss from long term securities denominated in foreign currency. The purpose of the measure is to protect firms from foreign exchange losses at a time the yen has been steadily appreciating (since 1971), and at the same time to reduce the balance of payments surpluses, which in turn have pushed the yen further upward and invited criticism from foreign countries. This measure, however, is to be phased out by the end of 1978, together with Item A.1. discussed above.

### 2) *Overseas investment loss reserve*

This measure is the most important measure with regard to Japan's direct foreign investment. Before discussing this measure, it is appropriate to review the implication of direct foreign investment in its context to the Japanese economy and her balance of payments. The basic position of Japan, as a resource poor but highly industrialized nation, demands that she must export to obtain food, fuel and raw materials that are necessary to keep the economy running. Exports have been encouraged not so much for their own sake but as a necessary means of earning foreign exchange, with which to finance imports of food, fuel and raw materials.

For this reason, Japan has adopted various measures to promote exports as we have already seen, notably tax exemptions for export income until 1964, and export cartels some of which now, ironically, play a lopsided role in administering the "voluntary" export restrictions. Since Japan had generally suffered chronic deficits in current accounts until 1967, transactions that contributed to draining foreign exchange were actually discouraged, except for imports of fuel and raw materials. This meant that foreign investment, be it direct or indirect, was also *discouraged* through controls on foreign exchange, capital transactions and the ubiquitous "administrative guidance" by the Ministry of International Trade and Finance. [9]

**TABLE 2**

**Japanese direct foreign investment 1961-75 (In million dollars)**

| Year | Amount | Year | Amount | Year | Amount |
|---|---|---|---|---|---|
| 1951-60 | 283.0 | 1966 | 227.1 | 1971 | 858.3 |
| 1961 | 164.2 | 1967 | 274.5 | 1972 | 2337.9 |
| 1962 | 98.3 | 1968 | 556.7 | 1973 | 3497.5 |
| 1963 | 125.7 | 1969 | 665.0 | 1974 | 2396.0 |
| 1964 | 118.5 | 1970 | 904.2 | 1975 | 3279.0 |
| 1965 | 159.4 | | | 1951-75 | 15943.0 |

Source: Japan, Ministry of International Trade and Industry (MITI), *Keizai Kyoryoku no Genjo to Mondaiten* (Economic Cooperation and Its Problems).

8. Japan Ministry of International Trade and Finance, *Tsusho Hakusho-Kakuron* [White Paper on International Trade] (Tokyo: Ministry of Finance Printing Office, 1977), pp. 920-22.

9. For that matter, not only capital outflow but also capital inflow was discouraged until 1967. Japan has substantially liberalized capital inflow through a successive round of liberalization measures during 1967-71. Among the reasons for re-

**TABLE 3**

**Japanese and U.S. investment oustanding, by industry, 1974**

| Industry | JAPAN | | | UNITED STATES | | |
|---|---|---|---|---|---|---|
| | Investment outstanding (Million dollars) | Percentage | Av. growth rate 1970-74 | Investment outstanding (Million dollars) | Percentage | Av. growth rate, 1970-74 |
| Resources | 4,084 | 32.2 | 35.4% | 36,372 | 30.7 | 7.8% |
| (Mining) | (3,804) | (30.0) | (35.4) | – | – | – |
| Manufacturing | 4,139 | 32.7 | 44.9 | 50,915 | 42.9 | 13.1 |
| Tertiary | 4,443 | 35.1 | 33.7 | 31,326 | 26.4 | 15.8 |
| Total | 12,664 | 100.0 | – | 118,613 | 100.0 | – |

Source: Japan, MITI, *Keizai Kyoryoku,* U.S. Dept. of Commerce *Survey of Current Business.*

However, in 1968, Japan began to register surpluses in the current accounts, and it was apparent by 1971 that the surpluses took a firm foothold in her balance of payments. Although Japan was already in the net creditor position in the long term asset-liability outstanding in 1967, foreign investment took a dramatic turn when, in 1972, direct investment reached the $2 billion mark on an annual basis (Table 2). In a sense this outcome has been both a reflection of Japan's concern for criticism abroad about her "excessive" exports and a growing protectionist sentiment in some countries, and an attempt to reduce balance of payments surpluses.

At present, direct foreign investment is, in effect, encouraged by two broad measures: one is through agreements concluded by Japan with thirty countries for preventing double taxation.[10] The other is the measure for the overseas investment loss reserve, specifically designed for investment in less-developed countries, resource development and large scale governmental projects with private participation in the LDC, which are to be taken up under the present heading. The following is an account of provisions in force of the three categories under the present heading, all of which are short-run measures by nature.[11]

i) Investment in the less developed countries

When the total of Japanese capital accounts for 10 percent or more in a single project, 30 percent of the invested sum can be set aside for a reserve account for possible future losses. However, after five years, the sum must be added to the taxable income over the following period.

ii) Investment in resource development

The amount allowed for reserve is 100 percent for investment or loan for *exploration* for petroleum, natural gas, ferrous metals, coal and fluorite. It is 40 percent for investment and loan for *development* of the resources mentioned above plus lumber. However, again, all the money set aside for reserves must be added back to the taxable income after five years over the following five-year period.

iii) Investment for large governmental projects in the the less developed countries

Firms participating in large scale projects, involving more than 100 billion yen ($400 million) with a minimum of three years for completion, and contracted by the governments, are allowed to set aside for reserves 7 percent of actual expenses. However, this reserve, too, must be added back to the taxable income over five years after a five-year grace period.

In summary, until 1964, a strong case could be made to justify the existence of export promotion through exemption of export income from tax liability. However, since 1964, no such tax exemptions or subsidies for export promotions per se exist in Japan. Although export "cartels" do exist in certain industries under administrative guidance, some of them are now playing a lopsided role in administering the voluntary export

strictions of inflow was that Japan had an ample supply of domestic capital and management. However, some suspect xenophobia as a reason for the restriction of capital imports. See Lawrence B. Krause and Sueo Sekiguchi, "Japan and the World Economy" in Hugh Patrick and Henry Rosovsky, ed., *Asia's New Giant: How the Japanese Economy Works* (Washington, D.C.: Brookings Institution, 1976), pp. 383-458.

10. These countries are: the United States, Sweden, Norway, Denmark, Pakistan, India, Singapore, Austria, the United Kingdom, New Zealand, Thailand, Malaysia, Canada, France, West Germany, Brazil, Sri Lanka, Belgium, the United Arab Republic, Australia, Italy, Zambia, the Netherlands, South-Korea, Switzerland, Finland, Spain, Ireland, Romania and Czechoslovakia. *An outline of Japanese taxes 1977,* Tax Bureau, Ministry of Finance, Tokyo (1977) at 219-221 and *Supplementary Service to European Taxation,* Sec. C. Vol. I, International Bureau of Fiscal Documentation.

11. Ministry of International Trade and Industry, op. cit., p. 922.

control imposed under pressure from abroad. As for direct investment, until 1971, this was actually discouraged through foreign exchange controls and restrictions on capital transactions as well as through intricate administrative guidance — largely for reasons of balance of payments. It must be pointed out that even at present there are no special measures such as tax exemptions or subsidies for *manufacturing* firms solely for the purpose of promoting foreign investment.

However, in direct investment or loans involving less developed countries, resource development, and large projects contracted between governments with private participation, there are exemptions for possible losses. To the extent that a significant share of Japan's direct investment is in mining and other resource fields (Table 3), the fact may partly reflect the benefit of this measure. However, if losses do not occur in the specified period, these reserves are gradually liquidated and become a part of taxable income. Since they are not outright exemptions, these reserves for losses resemble an accelerated depreciation rather than an exemption. Nevertheless, the reserve measure does constitute a form of subsidy.

## Conclusion

In the light of no fiscal incentives being provided for Japan's exports at present, the reasons for her continuing high export performances must be looked for elsewhere. These reasons may include among others: (1) the existence of a highly skilled, motivated and loyal work force; (2) high productivity of both labor and capital; (3) the lifetime employment system and the consequent drive for export efforts to keep firms operating even at a temporary loss, since under such a condition, labor is akin to fixed cost; (4) the firms' access to bank loans, which in turn are financed by the Bank of Japan's "overloan" facilities; and (5) the foresighted strategy for exports based on business-government cooperation.[12]

As for direct foreign investment, there are some fiscal incentives for investment in resources and in developing countries, but not in manufacturing or in developed countries. The reasons for the surge of Japan's direct foreign investment in recent years must again be sought elsewhere. These reasons may, among others, include: (1) the concern for securing stable sources of raw materials; (2) increasing labor costs in Japan and resulting efforts for seeking countries which offer lower labor costs; (3) the decreasing gap in technology between Japan and the other industrial nations; (4) in case of service industries, especially in banking and other financial activities, Japan may have a comparative advantage dating back at least 350 years; (5) concern for protectionist sentiments abroad and resulting attempts to "jump" over the present or future tariff walls.

Some of these reasons were already documented.[13] There may be many more reasons for Japan's continuing high performance in exports and the surge in direct foreign investment, each of which requires careful empirical work and documentation. At any rate, considering Japan's perennial need and concern for secure sources of raw materials and its swelling reserve accumulation which reached $19.1 billion as of November 1977, Japan's direct foreign investment, aside from her exports, is likely to grow in future with or without fiscal incentives.

12. Sanford Rose, "The Secret of Japan's Export Prowess", *Fortune*, January 30, 1978, pp. 58-62.
13. Japan, Ministry of International Trade and Industry, *Waga-kuni Kigyo no Kaigai Jigyo Katsudo* [Foreign Business Operation of Japanese Firms], 1975.

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# Japan and the European Community*

## 1. Introduction

The European Community and Japan are two of the three principal industrial powers practising a market economy — the United States is the third. They thus play a key role in major international negotiations on economic matters, such as the multilateral trade talks in GATT.

## 2. Japan-EEC relations progress with the help of standing machinery for discussion

For some years the Community has been doing its best to intensify its relations with Japan. The Nine decided at the Paris Summit (1972) to work for more active discussions between the enlarged Community and other industrial countries. Following this decision the Commission instituted, in June 1973, regular top-level discussions with the Japanese Government to be held twice a year on approximately the same lines as those held with the United States administration. These consultations are concerned not only with problems of bilateral interest, but also with the big economic problems of multilateral concern.

With the permanent delegation set up in Tokyo in November 1974, the EEC now has an established liaison instrument, enabling discussions to be intensified and the links with Japan to be drawn closer.

From 1975 onwards, exchanges of views have become more and more frequent.

Mr. Finn Olav Gundelach, Member of the Commission, paid an official visit to the Japanese Government from 12 to 15 July 1976.

Mr. Doko, President of Keidanren (the Federation of Japanese Industries), headed an important delegation of Japanese industrialists for talks with the Commission on 26 October 1976.

The tenth meeting under the regular top-level consultation arrangements between the EEC and Japan was held in Tokyo on 19 and 20 May 1977. On this occasion Mr. Haferkamp, Vice-President of the Commission, visited Tokyo for talks with the Prime Minister, Mr. Fukuda, and other members of the Japanese Government. This was also the first time since 1973 that consultations between the European Community and Japan had taken place at ministerial level.

The two parties agreed that they must co-operate closely in order to deal with the Community's worsening trade deficit with Japan. The Community delegation emphasized the necessity for further rapid progress in eliminating in Japan the barriers to Community exports to that country. It was agreed that the sector-by-sector study of this problem would be speeded up with the aim of making it easier to take advantage of the opportunities for Community exports in such areas as processed agricultural produce, chemicals, pharmaceuticals and diesel engines.

## 3. The EEC trade deficit

The growing Community trade deficit with Japan has for some time been a major political problem. In 1970 the trade was still almost in balance; but from US$300 million in that year the Community deficit rose to about $4,000 million in 1976; in 1977 it will amount to $5,000 million. At the same time the cover-ratio (the proportion of the cost of imports covered by exports) has fallen to less than 40%, as the following table shows:

| *Year* | *Deficit* | *Cover ratio* |
|---|---|---|
| 1973 | $1,200 million | 67% |
| 1974 | $1,900 million | 63% |
| 1975 | $3,200 million | 46% |
| 1976 | $4,100 million | 43% |
| 1977 (Jan/June) | $2,500 million | 39.5% |

*Source:* Eurostat

Though it is true the Community deficit in the trade balance with Japan is partly offset by a surplus in the balance of invisible transactions, there is some discussion as to how big this surplus really is. From the Japanese side, the figures put forward indicate that in 1975 Japan was still facing a very big deficit in its balance in invisibles with the EEC, the amount suggested being $2,000 million, of which $1,500 million was with the United Kingdom alone. The latter figure is disputed by the British authorities, who argue that the way the Japanese have calculated their figure includes transactions carried out in the London market, but on behalf of other countries. The British calculations show a much smaller deficit, of the order of $400,000, corresponding to revenues actually received by the United Kingdom.

CONTENTS



The reaction of public opinion and specifically industrial opinion in Europe to the EEC trade deficit with Japan is all the more vocal since the Japanese exports are concentrated in a few sensitive sectors: cars, steel, ship-building, electronic goods and ball-bearings. In some cases, Japanese penetration of the European market has reached considerable proportions, which may give rise to market disturbances and employment problems.

This trade takes place in one direction only without European goods being able to penetrate the Japanese market to the same extent. The most striking example is that of automobiles. Japan has a 4.38% share of the European market, whereas the Community has only a 0.8% share of the Japanese market. In other industries the Japanese penetration reaches still higher levels — ball-bearings 8.9% and electronic calculators over 60% — without the Europeans being able to make any sales at all in Japan under these headings.

It should be mentioned that the Member States of the Community still apply national quantitative restrictions on some 79 industrial products, whereas Japan applies quantitative restrictions in only 27 cases, of which 22 are for agricultural products and only 5 for industrial goods.

* Reprinted from "INFORMATION" No. 164/77 issued by the Information Directorate-General of the Commission of the European Communities.

**Community imports from Japan (US$ millions)**

| | 1972 | 1973 | 1974 | 1975 | % change 1975/74 | 1976 | % change 1976/75 |
|---|---|---|---|---|---|---|---|
| Germany | 989 | 1350 | 1349 | 1760 | (+ 30) | 2159 | (+ 23) |
| United Kingdom | 782 | 1083 | 1412 | 1564 | (+ 10) | 1531 | (– 2) |
| France | 364 | 542 | 946 | 995 | (+ 5) | 1231 | (+ 24) |
| Italy | 250 | 370 | 438 | 454 | (+ 3) | 589 | (+ 30) |
| Belgium/Luxbg. | 191 | 268 | 340 | 418 | (+ 23) | 557 | (+ 33) |
| Netherlands | 249 | 318 | 420 | 505 | (+ 20) | 631 | (+ 25) |
| Denmark | 104 | 203 | 258 | 216 | (– 17) | 357 | (+ 65) |
| Ireland | 26 | 38 | 50 | 66 | (+ 32) | 93 | (+ 41) |
| EEC Total | 2955 | 4172 | 5213 | 5978 | (+ 15) | 7149 | (+ 20) |

**Community exports to Japan (US$ millions)**

| | 1972 | 1973 | 1974 | 1975 | % change 1975/74 | 1976 | % change 1976/75 |
|---|---|---|---|---|---|---|---|
| Germany | 612 | 1028 | 1258 | 963 | (– 23) | 1110 | (+ 15) |
| United Kingdom | 430 | 668 | 746 | 681 | (– 9) | 646 | (– 5) |
| France | 226 | 420 | 463 | 375 | (– 19) | 423 | (+ 13) |
| Italy | 152 | 277 | 322 | 297 | (– 8) | 320 | (+ 8) |
| Belgium/Luxbg. | 106 | 198 | 218 | 152 | (– 30) | 178 | (+ 17) |
| Netherlands | 78 | 142 | 178 | 150 | (– 16) | 191 | (+ 27) |
| Denmark | 42 | 78 | 92 | 122 | (+ 32) | 129 | (+ 6) |
| Ireland | 11 | 16 | 21 | 20 | (– 5) | 42 | (+110) |
| EEC Total | 1657 | 2827 | 3298 | 2760 | (– 16) | 3040 | (+ 10) |

**Community trade balance with Japan (US$ millions)**

| | 1972 | 1973 | 1974 | 1975 | % change 1975/74 | 1976 | % change 1976/75 |
|---|---|---|---|---|---|---|---|
| Germany | –377 | –332 | –91 | –797 | (+ 775) | –1049 | (+ 32) |
| United Kingdom | –302 | –415 | –666 | –883 | (+ 33) | –885 | (+ 0) |
| France | –138 | –122 | –483 | –620 | (+ 28) | –808 | (+ 30) |
| Italy | –98 | –93 | –116 | –157 | (+ 35) | –269 | (+ 71) |
| Belgium/Luxbg. | –85 | –70 | –122 | –266 | (+ 118) | –379 | (+ 42) |
| Netherlands | –171 | –176 | –242 | –355 | (+ 47) | –440 | (+ 24) |
| Denmark | –62 | –125 | –166 | –94 | (– 43) | –228 | (+143) |
| Ireland | –15 | –22 | –29 | –46 | (+ 59) | –51 | (+ 11) |
| EEC Total | –1298 | –1345 | –1915 | –3218 | (+ 68.1) | –4109 | (+ 28) |

These restrictions, however, have not prevented Japanese products from penetrating the European market in the sectors mentioned above, except perhaps in the case of Italy, where cars and ball-bearings from Japan are subject to quota. It is often by administrative obstacles and other non-tariff barriers, however, that the penetration of European goods into Japan is prevented.

## 4. The Community attitude

During the past two years, the Commission has made many representations to the Japanese authorities drawing their attention to this situation and to the dangers involved if a better balance is not struck in trade between the EEC and Japan.

In its discussions the Commission has consistently argued that the best way of securing a more satisfactory balance would be to increase Community exports to Japan, rather than to impose import restrictions at the Community end. However, a further point to be made is that in face of the continued worsening of the deficit and increasingly serious sectoral problems, at a time when the Community has not yet emerged from the recession, it would be more and more difficult for the Community to maintain its previous attitude of avoiding restrictive measures if Japan did not take effective steps to promote Euroepan exports and limit its own exports temporarily in specific cases.

Consequently, at the two meetings of the European Council in November 1976 and March 1977, the Heads of Government discussed relations with Japan. They expressed their concern over the problems caused by imports from Japan. They also asked the Community authorities to continue their efforts to achieve a better balance, emphasizing in particular the need to increase the Community's exports to Japan. The European Parliament made the same point in its resolution of 10 March 1977 on relations with Japan.

*Sector difficulties*

For sector difficulties traceable to the imports from Japan, the Community is in a position to use the instruments of the common commercial policy.

Between 1974 and 1976 Japanese exports of *ball-bearings* to the Community rose by 40% in the case of ball-bearings and 100% for conical bearings. The proportion of the market covered by imported bearings from Japan increased by 40% for ball-bearings and 100% for conical bearings, representing respectively rises from 1.2% to 16.8% and from 2.6% to 5.3% of the Community market.

On 13 November 1976 the Commission opened an enquiry under the anti-dumping procedure and on 5 February 1977 it decided to introduce a temporary anti-dumping duty of 20% on ball-bearings. This anti-dumping duty was renewed for a further three months with effect from 5 May. On 26 July the Council of the European Communities adopted the Regulation introducing a 15% duty on imports of bearings (ball- and conical bearings) originating in Japan. At the same time it suspended application of this duty in the light of assurances given by the Japanese manufacturers, in particular as regards prices of Japanese exports.

Regarding *steel*, the Commission has been in contact with the Japanese authorities since 1975 with a view to examining forecasts of Japanese exports to the Community. At the meeting of the ECSC-Japan contact group in Brussels on 11 and 12 November 1976, the Japanese authorities gave details of their forecasts for 1977, pointing out that exports to the Community in 1977 would be reduced sufficiently to avoid any repitition of the difficulties previously experienced on the European market. In September 1976 the Japanese authorities had also given certain information and assurances about exports of special steels to the United Kingdom.

For *ship-building*, which is now in a state of crisis, there is a special problem. The Community is anxious to secure an international consensus under the auspices of the OECD on the reduction of production capacity. Japan has recognized that capacity must be reduced if the imbalance between supply and demand in this industry is to be eliminated. Japan also confirmed that it was not seeking to enlarge its share of the world market. Various ways of settling the problems outstanding will be discussed at regular consultations between the Community and Japan.

Japan has adopted the following measures:
- 5% increase in prices for ships of all types;
- elimination of a further 30,000 jobs in ship-building by the end of 1978;
- turning away of orders from Member States which are particularly hard hit by the crisis. Directives to this effect have already been issued as regards orders from Germany and Holland.

Consultations between Japan and the Community on ship-building will take place every three months.

With regard to *cars*, Japanese exports in the nine EEC countries reached 370,000 in 1975 or 50% more than in the previous year; but Community sales in Japan amounted to only 26,000 cars, a minimal rise of only 3.2%. In 1976 the imbalance was even more marked, with 491,000 Japanese cars entering the Community against only 25,000 Community cars sold to Japan.

The Japanese scored a much higher degree of penetration in the EEC countries which do not produce cars (Belgium 16.7%, Netherlands 15.5%, Denmark 14.7%) than in the countries which do (Federal Republic of Germany 1.7%, France 1.6% and Italy, where imports are subject to quota, only 0.05%). In the United Kingdom, however, where the industry is having special difficulties, Japanese imports accounted for 9.5% of the market.

In other industries the Commission has been seeking solutions through cooperation with the Japanese authorities. For *textiles*, an agreement involving voluntary restraint by Japan of its own exports and providing for a consultation procedure was signed on 9 July 1976 under the Multifibre Arrangement. It is valid until 31 December 1977, with retroactive effect from the 1 January 1976.

*Increasing Community exports*

With a view to correcting the imbalance in trade between the EEC and Japan, the Commission has been pursuing an active commercial policy, aimed at increasing exports from Europe. It has made representations to the Japanese authorites, requesting them to eliminate existing administrative obstacles to the admission of European goods into Japan. The best known among these obstacles are lack of information, inadequate notice of new administrative requirements, laborious checking procedures and lack of authority to do testing and checking in Europe. Since October 1975, the Commission has been making approaches to the Japanese Government in an attempt to have non-tariff barriers eliminated in the automobile sector.

These representations have borne fruit. The Japanese authorities have accepted three European requests:
- as from 1 April 1977, acceptance tests on European cars will be carried out in Europe;
- in determining the conformity of European cars to Japanese legislation, the date taken into consideration will henceforth be the date of manufacture instead of the date on which the importation procedures were completed;
- the entry into effect of the stiffer NOx [1] emission standards, which come into effect in Japan as from 1 April 1978, is to be suspended for European cars until 1 April 1981.

In *pharmaceuticals*, the Japanese Government issued a new regulation on 1 October 1976 to the effect that results of certain pre-clinical tests carried out in Europe shall now be accepted for pharmaceutical products imported into Japan.

Consultations will take place shortly between the Community and Japan concerning chemicals, pharmaceuticals and marine diesel engines, with a view to the elimination of administrative barriers maintained by Japan.

For *processed agricultural products*, the Commission has listed a number of sectors in which the expansion of European exports is obstructed by Japanese regulations. These include quantitative restrictions for milk products and preserved pigmeat; customs duties in the 35% - 40% range for biscuits, sugar confectionery and chocolate confectionery; internal taxes on wine, whisky and brandy.

On this subject consultations between the EEC and Japan took place in Brussels on 7 and 8 February 1977 and in Tokyo on 18, 20 and 21 July. Japan made minor concessions on unsweetened condensed milk and certain manufactured tobacco. It was agreed that problems still to be resolved should be dealt with in the context of the multilateral negotiations in Geneva.

However, the two parties decided to set up a joint study group to investigate the possibility of promoting Japanese imports of European preserved foods.

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1. NOx: proportion of oxides of nitrogen in the emissions.

# SRI LANKA:
# FREE TRADE ZONE

by M.P. Dominic

The Greater Colombo Economic Commission Law was enacted in order to provide the institutional machinery for the development of a Free Trade Zone in Sri Lanka. Under this law, a zone equivalent to 200 square miles is carved out and the "Greater Colombo Economic Commission" will have very wide powers over the area. The Government is proposing to encourage the establishment of export oriented industries and of essential investment and export services, e.g. international banks, insurance companies, freight forwarding firms, etc., in the Free Trade Zone. The members of the Commission were appointed on February 9, 1978. The membership of the Commission includes two industrialists, an accountant, a lawyer and the Director General of the Export Promotion Secretariat.

The Greater Colombo Economic Commission Law provides for two types of enterprises which are eligible for special treatment under the law, namely "Area Enterprises" and "Licensed Enterprises".

An *"Area Enterprise"* is an enterprise with which the Commission has entered into an agreement and which carries on business or is proposing to carry on business, within its area of authority, namely the "Free Trade Zone".

A *"Licensed Enterprise"* is an enterprise with which the Commission has entered into an agreement and which carries on or proposes to carry on any business outside the Area of Authority, namely the "Free Trade Zone". Hence, the law is sufficiently flexible, so as to extend the special treatment which is to be provided to enterprises located in the "Free Trade Zone" also to enterprises located outside the "Free Trade Zone".

Special fiscal and non-fiscal incentives will be provided to the enterprises by the Commission under agreements made with such enterprises.

These incentives are:

1. A tax holiday period averaging five years from the date of commencement of commercial production.
2. After the expiry of the tax holiday period "income tax" on the turnover at the rate of 2 percent on sales to countries outside Sri Lanka and 5 percent on sales to Sri Lanka.
3. Ten percent withholding tax on all remittances of royalty and technical service payments after the tax holiday period.
4. All foreign personnel working for Greater Colombo Economic Commission licensed projects will be exempt from all taxes for the period of the tax holiday of the particular project.
5. All dividends paid to non-resident shareholders of the licensed area projects will be free of any further taxes of any sort and free of any exchange control.
6. Five year tax holiday for banking institutions permitted to operate in the Free Trade Zone Area. The Commission has indicated that Foreign Banks will be permitted to operate within the Zone and will be allowed local general banking facilities within the zone as well as offshore facilities.
7. After the expiry of the tax holiday, a 5 percent tax on offshore banking profits and approximately 25 percent on general banking profits.
8. Exemption from import duty on all imports of equipment, construction materials and inputs except general transport vehicles.
9. Freedom from import control on all imports by an enterprise authorized by the Greater Colombo Economic Commission.
10. Reduction or exemption of export duty on finished goods on the basis of capital investment, decree of possessing of local materials, technology etc.
11. Access to the local market on a negotiated basis for industries sited within the zone through a customs warehouse operated by the Greater Colombo Economic Commission on payment of Customs duty.
12. Concessions on imported materials for projects approved by the Commission but sited outside the zone provided the projects are 100 percent export oriented.
13. Allocation of sites in the zone on a 99 year lease basis on the payment of an initial premium plus an annual nominal fixed rent.
14. Provision of adequate and modern infrastructure facilities.
15. Provision for free transfer of capital, returns as well as the proceeds of liquidation in the "enterprise agreement" to be signed by the enterprise with the Commission.
16. Freedom to transfer shares in companies authorised to be established in the zone within or outside Sri Lanka to residents or non-residents and to decide the country of payment for such transferred shares.
17. Exemption of such transfers from any tax or levy in Sri Lanka.

**N.B.**

An enterprise authorised to be set up in the Free Trade Zone must be incorporated as a company in Sri Lanka. This requirement does not apply to Banks.

The Commission is also given power to liberalise the exchange control restrictions.

The Government is also proposing to encourage offshore banking activities and, for this purpose, the Greater Colombo Economic Commission Law specifically provides for permission for foreign banks to operate in Sri Lanka and for banks to operate secret numbered accounts. Special incentives are to be provided for encouragement of foreign deposits in banks established in Sri Lanka.

The Business Acquisition Act, under which the Government has power to acquire a business, is made inoperative in the Free Trade Zone.

# ADDITION TO

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## U.S.A.

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# HONG KONG BUDGET 1978 -77

# Tax Treatment of Interest & Offshore Banking Profits*

**b. Earnings and profits taxes**

*(i) Report of the Third Inland Revenue Ordinance Review Committee*

165. Quite apart from the need to bear in mind the economic, equity and administrative requirements of fiscal policy, therefore, I see a future need for the system to be reinforced to make it even more productive of revenue than at present, preferably at current rates. To this end, a small Working Party of officials, chaired by myself, has been examining the recommendations of the Third Inland Revenue Ordinance Review Committee and has come to certain conclusions, some of which have also been the subject of Government decisions.

*(ii) Taxation treatment of interest*

166. The Working Party gave priority to the taxation treatment of interest because there are a number of unsatisfactory features in the present law which the Review Committee attempted to resolve; and the taxation treatment of interest can be conveniently, and without prejudice, separated from the Review Committee's other major recommendations.

167. Under the Inland Revenue Ordinance, tax is levied at the standard rate on interest arising in or derived from Hong Kong. But the Ordinance lays down no test for determining the place where the interest arises in or is derived from. However, based on case law, it has been established that the test to be used is the provision of credit test, that is to say, the place where the credit is made available to the borrower. The Ordinance also exempts certain persons (e.g. banks) from payment of tax on interest as such and, in respect of these persons, profits from interest accruing to them as part of their business profits are chargeable to profits tax.

168. The provision of credit test to identify the source of interest chargeable to tax has proved open to manipulation. With the emergence of Hong Kong as a financial centre and with more sophisticated instruments now becoming available, there is a possibility that even further erosion of the yield from interest tax will be experienced. It has been found that loan agreements can be so structured that interest escapes Hong Kong tax completely even when the proceeds are remitted back to Hong Kong for use here. Whilst, originally, this manoeuvre was restricted to loans in foreign currencies and the Hong Kong borrower thus had to accept an exchange risk, a more recent development has been to link loans to the Hong Kong dollar.

169. As in the case of the charge on other forms of income, the Review Committee recommended that the existing charge on interest as such, and on interest which forms part of the profits of a business, should continue to be restricted to income arising in or derived from Hong Kong, but should be reinforced. So, *first*, in respect of interest generally, the Review Committee recommended that this reinforcement should be by way of extending the territorial source criterion, so as to tax interest received on funds used by the borrower to produce profts chargeable to Hong Kong tax unless, of course, the interest is already being taxed under the provision of credit test.[175] *Secondly*, the Review Committee recommended that, in respect of interest which forms part of the profits of banks (and other deposit-taking institutions), the reinforcement should be effected by including all interest which a banking business actively carried on in Hong Kong obtains without the substantial intervention of any branch elsewhere.[176]

170. When the Working Party considered the Review Committee's *first recommendation*, it accepted the argument that all significant flows of income which are the result of economic activity carried on in Hong Kong should be taxed. The Working Party was concerned, however, that the lender would not be able to calculate his tax liability, if any, until the use of the funds by the borrower had been established; and that, when the lender is not a bank or a corporation carrying on a trade or business in Hong Kong, the borrower would be, under the Review Committee's recommendation, responsible for deducting tax at source. Thus complicated questions of apportionment of funds used partly to generate Hong Kong profits and partly for other purposes would arise. This is incompatible with the withholding system.

171. The Working party concluded that *a* supplementary source test related to the activities of the borrower could be justified on the grounds that interest which arises from economic activities of a borrower in Hong Kong should be brought to charge; but the Government finally took the view that the implications of applying such a supplementary source test (i.e. of such a deeming provision) were unacceptable.

172. As regards the Review Committee's *second recommendation*, the Working Party agreed that the extension of the ambit of the profits tax charge to include interest which a banking business actively carried on in Hong Kong obtains without the substantial intervention of a branch elsewhere can be achieved within the framework of the territorial source criterion. The Working Party concluded that the recommendation could be implemented without too much difficulty and, indeed, it would somewhat simplify the preparation of tax computations.

173. The Government agreed with the Working Party that this recommendation should be accepted as it stands and a Bill to amend the Inland Revenue Ordinance will be published in the Government Gazette on Friday and, if passed into law, will be effective from the year of assessment 1978-79. The Government agrees with the Review Committee that it is a bank's organisation in Hong Kong, and the use to which that organisation is put to collect funds for lending, which are the source of its profits from interest. Thus, where such a business is carried on in Hong Kong, any resulting profits ought to be chargeable to tax here in the same way as commissions, fees and exchange profit dealings are charged at the present time. With the rapid expansion of off-shore business, an increasing proportion of the profits of these institutions would otherwise escape tax. There is no justification for this inasmuch as these profits are, in effect, derived from economic activities carried on in Hong Kong.

174. Based on present information in the Inland Revenue Department, and on various other assumptions regarding interest rates and coverage, the additional tax yield will be about $145 million in

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* Extracts from the 1978-79 Budget Speech by the Financial Secretary of Hong Kong, Mr. C.P. Haddon-Cave on March 1, 1978.

175. Recommendation (3) on page 64 of TIRORC Report.

176. Recommendations (1) and (2) on page 79 of TIRORC Report.

1979-80 and thereafter about $80 million per annum.[177]

175. This change in the law will have implications for profits from two separate types of activity. *First*, as regards profits derived from income received on funds borrowed in Hong Kong, but invested overseas: such overseas assets are normally denominated in foreign currencies, but not necessarily.[178]

The additional tax liability would be 17% of the net profits derived from such interest earnings. These overseas assets are normally acquired partly because banks would not otherwise be able to meet their statutory liquidity requirements, partly to service the foreign currency requirements of Hong Kong customers, and partly because of a lack of suitable instruments in Hong Kong. The after-tax profitability of banks will be reduced and banks with large net foreign currency positions will be particularly affected. However, at present, banks and similar financial institutions are in a very privileged tax position compared with businesses generally. Even taking into account any foreign tax payments, they presently enjoy an effective rate of tax here *well* below 17%.

176. *Secondly*, as regards the so-called offshore business conducted by banks and other financial institutions: lendings to non-residents are financed, not by borrowing of Hong Kong dollars, but by borrowing of foreign currencies from abroad. This type of business has been growing very rapidly and is conducted both by long-established local banks and overseas institutions recently established in Hong Kong solely for this purpose. At present such institutions do not have to pay profits tax on any interest generated by such business even though the business is carried on in Hong Kong. Under the proposed amendment to the law all such profits will be taxable. However, in many cases profits earned in Hong Kong by a foreign bank are liable to tax in the country where the head office of the bank is situated. This is particularly true when the operation is conducted by a branch rather than a subsidiary. Where there exists unilateral relief from double taxation, the only effect will be to reduce the tax paid to the country where the head office is situated. But where there is an increase in the overall tax liability, it could be argued that a danger could exist of this type of business being transferred elsewhere. On balance, I believe a substantial loss of such business to be unlikely; not only are banks reluctant to ascribe a tax motive to the form in which they do business, but also Hong Kong's tax advantages are certainly not the only reason why overseas institutions decide to conduct offshore activities here. For instance, those financial centres with virtually nil tax rates tend to be suitable for book-keeping activities only.

177. The payment of provisional profits tax for 1978-79 in the case of an established bank with an accounting date of 31st March is based on the preceding year, i.e. the year ending 31st March 1978. Since the proposed date of implementation is 1st April 1978 the tax yield in 1979-80 will be made up of:

(a) $80 million for final 1978-79 assessment; and

(b) $80 million for 1979-80 provisional assessment, *less* approximately $15 million which will fall due for payment in 1980-81 under the two instalment system.

178. Even when they are denominated in Hong Kong dollars, the provision of credit test may not be successfully applied (see paragraph 168 above).



 

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# Contents

of the May 1978 issue



**In next issues:**

Legal regulation of taxes, levies and fees in the Czechoslovak Socialist Republic
— by *Dr. Milan Bakes*

The German corporation tax reform and the revision of double tax treaties
— by *Dr. Theodor Faist*

Tax structure and fiscal policy
Japan: by *Mitsuo Sato*
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# The Future of Personal Taxation*

by Dr. Barry Bracewell-Milnes

## I. INTRODUCTION

*All taxation must ultimately fall on natural persons and in this sense all taxation is personal taxation. But corporation tax falls initially on legal persons; and the interplay of taxation at the level of the company with taxation at the level of its proprietors is a matter of considerable complexity, even though corporation tax generally yields only a modest proportion of total tax revenue. It is therefore convenient to distinguish corporate taxation from all other taxation and to use the term "personal taxation" to refer to the latter. Among the countries of the Organisation for Economic Co-operation and Development (O.E.C.D.) personal taxation generally accounts for nine-tenths of total tax revenue or even more; and it has its own internal logic embracing the interrelationships of all its components — the taxation of expenditure, of earnings, of investment income, of capital gains, of capital transfers, of wealth. It is the future of personal taxation in this sense that constitutes our subject now.*

*Any country's collection of taxes may be called its* tax system, *however disorderly and inconsistent it may be. In a narrower sense of the term, tax systems would be only those which could be regarded as* systematic. *This paper presents a common classification of tax systems in the first sense which enables us to compare their internal logic in the second. This in turn indicates the internal and external pressures which may be exerted on the various tax systems and how in consequence they may develop in the years to come.*

## II. FINLAND AND OTHER O.E.C.D. COUNTRIES

In recent years the international comparison of tax burdens within the Organisation for Economic Co-operation and Development has been facilitated by the O.E.C.D.'s *Revenue Statistics of O.E.C.D. Member Countries* which analyses tax yield in some detail for twenty-three countries (all except Iceland). To set the scene, Table 1 shows for a number of different taxes the position of Finland in 1975 relatively to (1) the other three countries of Scandinavia, total 4; (2) Scandinavia plus the European Economic Community, total 12; (3) the whole of the O.E.C.D., total 23.

Table 1 shows that Finland is not a high-tax country by comparison with her Scandinavian neighbours (column (1)). By comparison with Scandinavia plus the EEC (column (2)), Finland is a high-tax country except for social-security contributions and taxes on property; and the same holds good for the comparison between Finland and the rest of the O.E.C.D. (column (3)). The ratios of the various tax yields to gross domestic product at market prices are given for Finland in column (4). The revenue yields of Table 1, however, tell only part of the story. The relative burden of taxation in Finland and elsewhere is also indicated by the maximum rates of tax. Table 2 shows for the four Scandinavian countries and the European Economic Community the maximum rates of tax levied in 1976 on earned income, investment income, transfers to lineal descendants, capital gains, wealth, expenditure on goods and services. The rate of tax on expenditure on goods and services is calculated as the ratio of revenue yield to expenditure at market prices; 1976 is the last year for which this information is available.

Table 2 shows Finland in the sixth place out of twelve for the maximum rate of tax on earnings, fourth for investment income, eleventh for transfers to lineal

* Paper read on 19 April 1978 for the 10th anniversary of the foundation of the Finnish Branch of the International Fiscal Association.


### RESUME

The proportion of gross domestic product (or national income) taken by the government in taxation has risen during the last ten years in all the countries of the O.E.C.D. (Organisation for Economic Co-operation and Development). If this trend were not reversed, governments of the high-tax countries would be absorbing almost the whole of national income by the end of the century. Public expenditure has a built-in tendency to rise, and a sustained exercise of political will is required to bring the burden of public expenditure down.

Finland is not a high-tax country by Scandinavian standards, but she is within the O.E.C.D. as a whole. The taxable capacity of the wealthier taxpayer has been largely or completely exhausted in the more highly taxed O.E.C.D. countries, so that additional taxation falls primarily on middle and lower incomes. Conversely, middle and lower incomes are principal beneficiaries of radical reductions in the tax burden.

High rates and heavy burdens of tax have emphasised the anomalies and inequities in tax systems and thus increased the pressure for their reform. This pressure is likely to be exerted more and more in the direction of taxation on expenditure, perhaps at graduated rates. The logic of graduated expenditure taxation implies the reduction or abolition of taxes on investment income and its parent capital (capital gains, successions, gifts and wealth); and if tax is levied only on expenditure, adjustments for inflation are unnecessary.

descendants and third for expenditure on goods and services. But rates as well as burdens of taxes are generally lower in the other eleven countries of the O.E.C.D. than in Scandinavia and the European Economic Community. Finland is a high-tax country within the O.E.C.D. as a whole, more so than within Scandinavia and the EEC.

One simple indicator of possible future developments in personal taxation is what would happen if there were a move towards harmonisation of tax burdens or rate structures or both. Rate structures may be more significant than tax burdens for this purpose, since they are directly under the control of governments; and Table 2 shows how a move towards harmonisation would affect each of the countries concerned. But the tendency towards harmonisation is weak even within the EEC and weaker still outside. Indeed, rate structures are often stable for long periods despite changes in the political complexions of governments; the differences between countries are much larger than the differences between political parties. [1] Moreover, harmonisation is neutral between improvement and deterioration, between wisdom and folly. It is not desirable in itself; it merely provides the opportunity for improvement. So we turn to consider, first some recent and perhaps short-term trends and, second, some longer-term constraints and possible developments.

**TABLE 1**
**Relative and absolute tax yields in Finland 1975**

(1) - (3) rankings; (4) percentages

| | (1) Scandinavia | (2) Scandinavia + EEC | (3) O.E.C.D. | (4) Finland |
|---|---|---|---|---|
| Total tax revenue as percentage of gross domestic product (GDP) | 4 | 7 | 8 | 37.57 |
| Total tax revenue excluding social security as percentages of GDP | 4 | 4 | 4 | 33.52 |
| Tax revenue from income and profits as percentage of GDP | 3 | 4 | 5 | 19.69 |
| Tax revenue from personal income as percentage of GDP | 3 | 3 | 3 | 18.10 |
| Tax revenue from social security as percentage of GDP | 3 | 11 | 19 | 4.05 |
| Tax revenue from property as percentage of GDP | 3 | 11 | 21 | .77 |
| Tax revenue from goods and services as percentage of GDP | 3 | 4 | 5 | 13.06 |

## III. RECENT TRENDS [2]

*Tax burdens.* The ratio of taxation to gross domestic product rose between 1965 and 1975 in every O.E.C.D. country, the rise ranging from 1.5 percentage points in France to 14.6 in Luxembourg.

*Tax structures.* Personal income tax and social-security contributions increased most in relative importance between 1965 and 1975. General consumption taxes increased a little. Corporate taxes generally and excise duties everywhere declined as a proportion of total tax revenue; as a proportion of gross domestic product they increased in a number of countries, corporate taxes rising on balance and excise duties falling.

*Tax unit.* There is a trend away from the family as the taxable unit and towards the individual. In principle, this benefits married couples each of whom has a high earned income. But even where earned incomes are separable, investment incomes may still be aggregated.

*Children.* There is a trend away from tax allowances for children and towards tax credits or cash payments. In principle, this harms rich taxpayers with large families. When the change in the tax treatment of children is combined with the change in the tax unit, the rich lose if they have large families and gain if they are childless, especially if each spouse has a large earned income.

*Inflation.* The indexation of personal allowances and graduated tax bands has been spreading gradually under the pressure of events. Complete indexation is still more or less unknown (Brazil has perhaps gone further than any other country). Where indexation is partial, it is granted more liberally at the lower end of the scale. The indexation of allowances and tax bands provides relief only for earned income, since investment income would still lose from inflation (and might be annihilated) even if taxation were proportional; little has been done to relieve the taxation that is levied on nominal investment income even when the corresponding income after adjustment for inflation is negative.

*Tax expenditures.* Pressure groups are active in a number of countries to restrict what they call "tax expenditures", that is, reliefs against a notional "norm" of tax on income or whatever the tax base may be. But since any funds so released are as likely to be absorbed in additional government expenditure as they are to pay for cuts in the "normal" structure of tax rates, the principal beneficiary of any such trend might not be the taxpayer but the government.

*Social-security contributions.* Fewer and fewer people

1. Empirical evidence for this argument is contained in my book *The Measurement of Fiscal Policy* (Confederation of British Industry, London, 1971), especially page xv.

2. A detailed analysis of trends from 1965 to 1972 and 1974 is provided by two papers by Ken Messere, Head of the O.E.C.D. Taxation Division; (1) *Recent and Prospective Trends in Tax Levels and Tax Structures* (Institute for Fiscal Studies, London, 1975); (2) *Tax Levels, Structures and Systems: Some Inter-temporal and International Comparisons* (International Institute of Public Finance, Congress paper, 1976).

believe that social-security contributions have anything to do with insurance or are anything other than a tax. They are equivalent to a payroll tax on employers and an income tax on employees; for those who believe that income from investments should be taxed less heavily than income from earnings, social-security contributions have the merit of helping to achieve this result. Partly because social-security contributions are more and more regarded as simply a tax, the relative burden has shifted from employees to employers.

*Political cross-currents.* Taxes on saving, such as taxes on wealth, capital gains and capital transfers, are sometimes called the political taxes, because their revenue yield and cost of abolition are small and the motives for their introduction are political. Recent experience presents a mixed picture. All the main French parties are at present favourable to the introduction of a wealth tax; but Germany has been cutting the rate of wealth tax under a socialist administration and in the Budget of February 1978 the Irish government announced the repeal of the wealth tax which had been brought in only a few years earlier. Ireland introduced a capital gains tax in 1974 and France soon afterwards, and the question is under consideration in the Netherlands; in Britain, however, one of the first European countries to bring in a capital gains tax, the government were in the early months of 1978 actively considering the introduction of indexation or tapering relief in order to remove from charge most of the nominal capital gains due to inflation. Britain brought in a comprehensive capital transfer tax in 1975; but the abolition of estate duties is becoming a popular cry in Australia. Taxes have generally been going up in the O.E.C.D. countries over the last decade; but in Denmark a new political party captured a large number of seats in a recent general election on a programme of radical tax reduction. No clear trends emerge.

The developments noted in the present section are mostly superficial; and some could even be reversed. If we wish to assess future developments in advance, we nust look below the surface at the longer-term pressures and the logical constraints.

## IV. THE LONGER-TERM PRESSURES

*Tax burdens.* If tax burdens continued to rise as they have risen on average in the O.E.C.D. countries over the last decade, they would aborb the whole or nearly the whole of national income in the high-tax countries by the end of the century. Moreover, the taxable capacity of the rich has been largely or completely exhausted in a number of countries, so that additional taxation falls, and is perceived as falling, on middle-income and poorer

**Table 2**
**Maximum percentage rates of tax 1976**

| | (1) Earned income | (2) Investment income | (3) Transfers to lineal descendants | (4) Capital gains | (5) Wealth* | (6) Expenditure on goods and services |
|---|---|---|---|---|---|---|
| *Scandinavia* | | | | | | |
| Denmark | 66.67 | 70.00 | 32.00 | 50.00 | (1.000) | (25.41) |
| Finland | 77.00 | 80.00 | 11.00 | – | (4.000) | 25.51 |
| Norway | 69.30 | 90.00 | 35.00 | – | (2.600) | 29.44 |
| Sweden | 85.00 | 85.00 | 65.00 | – | (2.500) | 23.22 |
| *EEC* | | | | | | |
| Belgium | 63.00 | 63.00 | 17.00 | – | – | 17.03 |
| Denmark | 66.67 | 70.00 | 32.00 | 50.00 | (1.000) | (25.41) |
| France | 48.60 | 60.00 | 20.00 | – | – | 20.28 |
| Germany | 56.00 | 56.00 | 35.00 | – | 0.308 | 15.40 |
| Ireland | 77.00 | 77.00 | 55.00 | 26.00 | 1.000 | 27.79 |
| Italy | 72.00 | 72.00 | 44.11 | – | – | (13.67) |
| Luxembourg | 57.00 | 57.00 | 8.00 | – | 0.500 | 15.78 |
| Netherlands | 72.00 | 80.00 | 17.00 | – | (0.800) | 19.50 |
| United Kingdom | 83.00 | 98.00 | 75.00 | 30.00 | – | 15.57 |

* Where the figure in (5) is in brackets the figure in (2) is the overall limitation for income tax and wealth tax (in the Scandinavian countries and the Netherlands) subject to qualifications and exceptions varying from country to country)

*Notes:* Belgium (1) and (2) include local taxes. Denmark (1) is collective limitation of State income tax, national pension contribution, local income tax and county municipality income tax; (6) is for 1975, the latest year. Finland (1) includes 15 percent local income tax. France (1) is 60 percent minus 6 percent (= 10%x 60%) "frais professionnels" minus 5.4 percent ( = 10%x 54%) abatement for earned income (C.G.I. Article 158.5); (4) is nil because of exemptions for long-term gains. Germany (5) is netted down for the deductibility of income tax. Ireland (1) and (2) include 10 percent surcharge; the repeal of (5) was announced February 1978. Italy (1) and (2) exclude local taxes; (6) is for 1975, the latest year. Norway (1) includes 21.3 percent local income tax. Sweden (1) includes 27 percent local income tax.

*Sources:* *Taxation in Western Europe* (Confederation of British Industry, eleventh edition, 1974); European Taxation and Supplementary Service to European Taxation (International Bureau of Fiscal Documentation, Amsterdam); Tax News Service (IBFD, Amsterdam); Annemarie Mennel: *Die Steuersysteme in EWG Staaten, EFTA Staaten und den USA* (Verlag Neue Wirtschafts-Briefe, Herne, Berlin, 1974); Internationale Wirtschafts-Briefe; *Overzicht van de Belastingen* (European Commission, 1976).

taxpayers. Programmes of public spending are encountering more and more "consumer resistance" and tax reduction is becoming a more popular policy. In some countries where taxes have been rising fast, evasion is thought to have become more widespread as taxpayers find their own ways of opting out of an increasingly onerous system. For these reasons, the burden of taxation in the high-tax countries is unlikely to rise at recent rates and may even fall. A principal influence in the other direction is that government expenditure in a number of countries has for institutional reasons a built-in tendency to rise and will do so unless continuing political pressure is exerted to keep it down; indeed, government expenditure sometimes seems to be beyond human control for years at a time. Electoral and political pressure to contain government expenditure is likely to grow stronger in the high-tax countries though in the middle-rank and low-tax countries this development cannot be predicted with equal confidence.

*Maximum tax yield.* More evidence is being accumulated, for example in Britain, that some high taxes such as excise duties are being levied beyond the point of maximum revenue yield: in other words, the revenue yield would be increased, not reduced, by a cut in the rate of tax. The tax authorities will find it less easy than in the past to ignore the price elasticity of demand in calculating the effects of changes in rates on the revenue yield. They will find it less easy to argue that a 10 percent rise in the rate of tax from 80 percent gross (or 400 percent net) to 88 percent will yield a 10 percent rise in revenue. This constraint is particularly important for excise duties, which have been the least buoyant of the major components of tax revenue over the last decade; there have been calls from some quarters to increase rates of excise duty so as to restore the earlier relationship between the yield of excise duties and the yields of other taxes, but the effect of raising the rates of excise duty will be the opposite where these rates are already beyond the point of maximum revenue yield.

*Taxes on spending and taxes on saving.* It is becoming more widely understood that taxes are not all interchangeable in economic function. The traditional categories of direct and indirect taxes and taxes on income and taxes on capital are not the most helpful for making this distinction, since the boundary between direct and indirect taxation is unclear (a proportionate payroll tax might be described as either) and since the economic function of a tax on investment income is much the same as the economic function of a tax on its parent capital. The fundamental distinction is between taxes on spending and taxes on saving (investment income and its parent capital — capital gains, capital transfers, wealth). Taxes on earnings are a mixed category: at lower rates and on lower incomes they are much the same as taxes on spending, since virtually all the income is spent; at higher graduated rates and on higher incomes they bear increasingly on savings, since an increasing proportion of earnings is saved as income rises. The economic distinction is between taxes on spending, which are available to defray current expenditure and expenditure on "fixed" investment (plant, buildings, vehicles), and taxes on saving, which are available for financial purposes on capital account, such as the redemption of government debt or the payment of compensation for assets taken into government ownership. Taxes on saving cannot be used to defray the costs of current government spending or even fixed capital investment such as investment by nationalised industries or loss-making private industries; any attempt to use them for these purposes is inflationary. Although this constraint is still not widely understood, it is gradually sinking into the public consciousness; and it limits the political attractions of tax increases, since government spending, including transfer payments on current account, must be defrayed from taxes on spending, that is, from taxes falling preponderantly on the ordinary voter.

*Poverty trap.* The combination of personal allowances against income tax with a number of unco-ordinated means-tested payments in cash and kind to the poor has resulted in high effective marginal rates, sometimes exceeding 100 percent gross, as income rises above the poverty level and the means-tested benefits are withdrawn just as the taxpayer becomes liable to a positive rate of income tax. This phenomenon is known as the poverty trap or poverty surtax in Britain, but it is also to be found elsewhere; it is becoming more widely recognised and understood, and it is causing increasing dissatisfaction. The solution can only be the reduction of welfare payments below the critical levels or the reduction of tax rates above; under the first alternative taxation can be reduced and under the second it must.

In this section we have considered a number of longer-term pressures against tax increases and in favour of tax reductions. Most of them have to do with paradoxes limiting the political attractiveness of government expenditure financed by taxation. These limitations are increasingly effective as tax rates and tax burdens rise. Tax burdens are now so high in some countries that these limitations are more and more widely understood. Together, they indicate the need for the personal tax system to constitute an internally consistent whole. The poverty trap is a striking example of what can happen when this requirement is not satisfied: the victims are the very people whom the individual measures were designed to help.

## V. THE LOGICAL CONSTRAINTS

Most tax systems grow organically. Even large-scale reforms generally stop far short of being comprehensive. Real tax systems are thus more or less unsystematic. This may worry the academic or tax professional, but it does not much worry the layman. Systematic tax systems are to be found in the tax literature: but the ordinary citizen is mostly content to leave them there. Not the least of the reasons for doing so is the incompatibility of the various systems with each other. Income, spending, wealth, inheritance and land, for example, constitute very different tax bases; and it is not only politicians and men of affairs but also academics and tax professionals who may adulterate the purity of systematic tax systems by adopting uneasy compromises.

But people who have no interest in the logic of the tax system as a whole may be keenly aware and indeed resentful of particular inconsistencies and anomalies. We have already noted one example, the poverty trap. Another is high rates of income tax on overtime and other marginal earnings even at modest levels of income. Another is the levying of capital gains tax on nominal gains which even before tax are inadequate to offset the fall in the value of money since the asset was purchased. Another is the effect of price rises on graduated tax schedules unadjusted for inflation. Another is the subjection of small firms to such a severe tax regime that the number of jobs they offer falls and unemployment rises. Another is the emigration of taxpayers to more hospitable fiscal climates. Another is the growth of evasion as the tax system is considered more oppressive and less acceptable. Phenomena like this force themselves on the attention even of people with no natural interest in taxation; they create a demand for reform to remove the inequities and anomalies. The logical constraints, like the empirical constraints, reassert themselves simply because the tax system becomes less and less acceptable when they are violated. A gentle but pervasive pressure in favour of a logical system is also exerted by the preference for reforms with an inner coherence that is often to be found among those such as journalists and others whom Hayek has described collectively as the retailers in ideas. Reforms with a well-based rationale are easier to promote and defend and often receive a better Press.

Progress is impeded, however, by the conflict of the various tax philosophies and their competition for political and intellectual support. The problem is not that opinions differ about the proper basis or bases for taxation and the rates at which tax should be levied; these differences of opinion are neither avoidable nor undesirable. The problem is that the various systematic systems offer irreconcilable views of taxation, rather as different religions offer their rival interpretations of the universe. What is wanted, and what has been lacking, is a common framework of reference and discussion relating the various systematic systems to each other in terms equally appropriate to them all.

This framework has been lacking because of defects in the traditional terminology, to which I alluded earlier. In addition, the distinction between income and spending misses the category of new saving or personal capital formation, which is a component of outgo just as the yield of old saving is a component of income. The sum of earnings and investment income necessarily equals the sum of spending and new saving; and in the Western economies new saving is positive and substantial year by year. It is the neglect of new saving that has made the traditional analysis lopsided and has prevented the various systems from being brought into a logical relationship with each other. The most fundamental distinction is on the outgo side, between the taxation of spending and the taxation of saving. On the income side, earnings are a mixed category, since part is spent and part is saved; and investment income is merely the yield of saving made in former periods. Capital gains, capital transfers and wealth are likewise functions of saving made in former periods; and taxes on all these functions of saving, both income and capital, can be treated in common terms as equivalents of taxes on new saving at the time it is made. These concepts provide a common framework of reference for all systems of personal taxation specified in terms of income, spending, capital gains, capital transfers and wealth.

The conceptual apparatus I have described indicates the logical constraints on the policy maker. Saving and spending have a rate of exchange like the Finnish mark and the pound sterling. Their prices are reciprocals of each other: as one becomes dearer, the other becomes correspondingly cheaper. This is necessarily true for any taxpayer in any place and at any time. Thus the introduction of a wealth tax makes the rich man's spending cheaper and the introduction of a graduated expenditure tax cheapens his saving. In practice, saving is taxed much more heavily than spending at the top of the scale in all Western countries, so that the rich man's spending is cheap or even free. This is not the purpose of the various taxes on saving; but it is their inevitable result. Likewise, in a consistent system there is room for only one graduted tax schedule, whatever the distributive result desired. Earnings can be taxed at graduated rates, and so can spending or saving; but if there is more than one graduated tax schedule, the system is overdetermined. The logical constraints on the policy maker are such that he has only three primary variables at his disposition: the first is the height of taxation; the second is the relative taxation of spending and saving; and the third is the pattern of graduation for any one tax. When these three variables are specified, the essentials of a consistent tax system are determined. [3]

## VI. IMPLICATIONS FOR POLICY

Even though the analysis of the last section is wertfrei, it may have implications for policy. A logical framework that relates the various possibilities to each other in common terms may make some of the policy options seem more attractive than before and others less.

The *weight* of the tax system, in the sense of the aggregate tax burden, is substantially determined by the level of government expenditure. There are forces in motion which will limit, and may even reverse, the growth in the proportion of national income taken by Western governments; but the control of government expenditure requires a sustained political effort, since under contemporary Western institutions government expenditure has a built-in tendency to rise more rapidly than national income.

The *basis* of taxation, or the taxation of saving relatively to spending, is throughout the Western world more favourable to the rich man's spending than to the poor man's spending and more favourable to the rich man's spending than to the rich man's saving. I suggest that this is an untenable state of affairs that will be less and less acceptable as it becomes better and more widely

3. The analysis of this section is spelt out in my book *Is Capital Taxation Fair?* (Institute of Directors, London, 1974), especially Chapter IV.

understood. If it is thought appropriate that any element of graduation subsisting in the tax system should be made to apply to spending, in other words that the rich should pay more for their spending than the poor, the policy implication is that there should be a graduated tax on personal expenditure. But we have already noted that in a consistent tax system graduation can be taken only once. Graduated taxes on saving in the form of investment income or capital gains or capital transfers or wealth are diametrically in conflict with the graduated taxation of expenditure. This conflict is better understood for investment income and capital gains than for wealth and, in particular, capital transfers (bequests, legacies and gifts). Thus, the recent report of the Meade Committee [4] recommended graduated expenditure taxation combined with graduated taxation of capital: although the move away from income taxation would do something to reduce the taxation of saving relatively to spending at the top of the scale, the taxes on capital would still cheapen the rich man's spending; on balance, the rich man's spending might well be cheaper, even much cheaper, than both his own saving and the poor man's spending, a result diametrically in conflict with the rationale inherent in the graduated taxation of expenditure. Those logical constraints are inexorable and will become more widely understood. There is a choice to be made between the graduated taxation of saving and the graduated taxation of spending; if, as I believe, the graduated taxation of spending has a wider and deeper political appeal, the graduated taxation of saving is living on borrowed time. And similar considerations hold good for proportional taxes and at the lower end of the scale. Taxes on saving yield little revenue and are of little value economically, since their usefulness is restricted to the government's financial capital account. Moreover, there is no need for a separate tax on saving in order to achieve parity between saving and spending: taxes on spending fall equally on saving in the sense that they reduce the value of saving by reducing its spending power. Taxes on saving are vulnerable to these arguments throughout the scale of income or wealth.

Tax *graduation* suits the temper of the age and is likely to persist for many years whatever the force of contrary arguments in principle. But our argument suggests two possible developments. One is a shift in tax graduation from saving to spending or perhaps to earning as a compromise between the two. The other is a reduction of graduated rates of tax at the top of the scale if it becomes more widely understood that taxes on investment income, capital gains, capital transfers and wealth are all levied on a single taxable object, namely saving; and that the principle of graduation, namely taxing the rich more heavily than the poor, is exhausted when the combination of these taxes renders saving futile by confiscating the whole of the yield. When this position has been reached at the top of the scale, as it has in Britain and perhaps in some other Western countries, the principle of graduation goes into reverse. Nobody can be deader than dead: further increases in the graduated taxation of saving, for example through the addition of a wealth tax to a system that was already confiscatory, have no effect on the corpses of the rich. The victims of this fiscal overkill are the citizens of middle rank; the more the "progressive" taxes on saving are multiplied, the more "regressive" the results. Although most O.E.C.D. countries are not in a position where the taxation of saving at the top of the scale is demonstrably confiscatory, the argument is relevant to the numerous countries where the taxation of saving may be considered to reach or at least to approach this boundary: at this level, the victims of additional graduated taxes, and the beneficiaries of their reduction, are not primarily the richest taxpayers but those of the middle rank. This is another example of the conflict between appearance and reality; as the reality becomes better understood, the pressure for reductions in the higher rates of tax on saving is likely to increase. [5]

The burden of the argument so far has been that there are pressures both of logic and circumstance in the direction of lower taxes on saving, especially at the top of the scale. The weight of taxation in general will be determined by the level of government expenditure, where conflicting forces are at work; and tax graduation is likely to persist for many years, at least on earning as a substitute for expenditure. But the clearest conclusions concern the taxation of saving; and there is an additional pressure pushing the tax system away from saving and towards spending; inflation. Inflation adjustments to the taxation of saving are complex and contentious; if the tax base is expenditure, no adjustment is necessary. The importance of inflation and its relevance to taxation have sunk so deep into public consciousness in the Western world during the last few years that even a substantial and sustained reduction in the rate of price rises might do little to weaken the argument that the tax system should allow for inflation; and if proper allowance is made for inflation, the first beneficiary must be saving, through relief from taxes on wealth and capital transfers as much as from taxes on income and capital gains, since all four taxes are substitutes for each other as means of taxing the nominal yield from saving without adjustment for inflation.

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4. *The Structure and Reform of Direct Taxation.* Report of a Committee chaired by Professor J.E. Meade (George Allen and Unwin for the Institute for Fiscal Studies, London, 1978).

5. The analysis of tax policy in terms of the three dimensions of weight (or height), basis and graduation (or intension) is the subject of my book *The Measurement of Fiscal Policy* (Confederation of British Industry, London, 1971).

# The Definition of Statutory Net Income in Schedular and Global Income Tax Systems*

by Prof. Dr. Sylvain R.F. Plasschaert**

## 1. INTRODUCTION

1.1. In designing the income tax, the legislature must not only provide an answer to the difficult problem of defining gross taxable income, but must also clearly specify which sums are allowed as deductions from gross income in order to arrive at the ultimate basis on which a given rate or given rates must be applied, and which we shall call the "statutory net income". As indicated below, and although this paper focuses on tax design aspects, the techniques used in "netting out" taxable income matter less than the tax principles, or rationales, underlying those techniques.

1.2. According to these rationales, the following five categories of deductions should be distinguished and will be discussed in the same order:

(a) income production costs, i.e. expenditures incurred in the production of income;
(b) basic personal deductions;
(c) deductions for dependents;
(d) privileged personal deductions;
(e) incentive or reallocative deductions.

1.3. More specifically, we want to ascertain whether such deductions conform to the principles that underly the two basic types of income taxation, viz. the schedular (or analytical) and the global (also called synthetic (al) or unitary) systems. We examine whether each of the various deductions meets the "conformity test", i.e. is consonant with the canons of the schedular or the global system respectively.

1.4. In a schedular system, each type or category of income, say net wages or dividends, is taxed separately, normally each at a different flat rate, whereas under a global system, the sum of all net incomes that accrue to the same taxpayer from various gainful occupations or productive assets is subjected to a single tax, normally at one set of progressive rates. [1]

1.5. To begin with, a few remarks are in order:

(a) unless otherwise indicated, we use the term "deduction" in a generic sense. It covers all sums that are eligible for subtraction from gross income. When taken in a more technical sense, deductions represent actual expenditures which can statutorily be subtracted from gross income; deductions are then contrasted to "allowances", which "do not correspond to actual amounts or percentages of income but are specific amounts or amounts based on percentages established by the income tax law". [2] Both deductions, in the narrow sense, and "allowances" represent "subtraction (of) income from income". As will be shown hereafter, similar reductions of tax liabilities can be achieved through other techniques, such as the "subtraction of tax from tax" or, in the usual jargon, by "tax credits";

(b) in the opening paragraph we labelled the income tax base "statutory net income". The use of the term "statutory" was on purpose, to indicate that the effective taxable base may be well below the one intended by the law, e.g. on account of evasion and other causes of underreporting. Throughout this paper, we shall abstract from the gap between "effectively taxed" and "statutory net income", since we are concerned, in essence, with a tax design problem;

(c) a look at actual (in this paper also designated as "empirical") income tax statutes is in order, both to exemplify the tax principles and techniques under discussion and to throw light on the causes of the frequent divergence between the empirical phenotypes and their rational prototypes. But there is no need to exhaustively list the deductions in a number of tax statutes, if the points made can easily be proven or illustrated with a few examples. We shall, however, cover, in some detail, the statutory provisions in the United States and in Colombis, as the latter have been investigated in depth in various monographs and as their quantitative importance has been assessed. [3]

* This article is part of an extensive enquiry into the tax design and tax policy aspects of alternative income tax patterns, with particular reference to developing countries.

** Professor at the University of Antwerp, University Faculties St. Ignatius (Belgium).

1. See, for further elaboration of the two tax functions involved, *Sylvain R.F. Plasschaert*, "First Principles about Schedular and Global Frames of Income Taxation", Bulletin For International Fiscal Documentation, March 1976, p. 99-111.
2. As defined in the World Tax Series Monographs on the tax systems of various countries, prepared by the International Tax Program of Harvard Law School, where other technical definitions are given that are not required for our purposes.
3. The main sources are *Richard Goode*, "The Individual Income Tax", revised edition, The Brookings Institution, 1975 and "Fiscal Reform for Colombia. Final Report and Staff Papers of the Colombian Commission on Tax Reform", ed. *Richard A. Musgrave and Malcolm Gilles*, International Tax Program, Harvard Law School, 1971, hereinafter called Musgrave and Gilles.

## 2. INCOME PRODUCTION COSTS

2.1 At the level of tax principles, there can be no doubt as to the eligibility for deduction of outlays incurred in producing or receiving taxable receipts. For one thing, the income tax is based on a net income base concept; if a gross concept were adopted, the taxpayer would be partly imposed on expenditures instead of exclusively on incomings. Besides, taxation on a gross receipts basis would imply duplication of tax, as both the recipient of gross receipts and the latter's supplier of inputs would be hit.

2.2 The implementation of the above principle runs into a great many difficulties, and a substantial number of pages in any income tax statute, and of litigation, relates to the exact delineation of deductible and non-allowed income production costs. Part of the problem arises from the fact that, in principle, the income tax law does not pass judgement on the desirablility of such costs but accepts the costs that have actually been incurred. This allows some scope for taxpayers to inflate costs, as, at a 50 percent rate for example, each dollar spent is half subsidized by the State. Lavish "expense account" outlays are a case in point. In fact, delineation problems with respect to allowable business deductions are most numerous and difficult in the business sector.

2.3. *Conformity test.* It is almost superfluous to investigate whether the deductibility of income production costs conforms to the two types of income taxation, since such deductions are essential to any income tax system. But another interesting feature is frequently overlooked. As stated in a previous paper, the global approach can be termed a second-stage superstructure of a schedular infra-structure. In the first stage, the various incomes which a given taxpayer may obtain must be identified and their net amount determined. Only after the net incomes are aggregated into total net income are progressive rates applied. [4] Now, technically, it would be conceivable to place all deductible income production costs in a separate section of the tax code, instead of discussing each of them with their corresponding gross taxable receipts. Such lumping together, however, would be confusing and impractical. As a matter of fact, by their very nature, income production costs relate to a given source of gross receipts. Besides, the typical pattern of income production cost deductions greatly differs amongst the various categories of gross receipts. For example, business profits are normally a residual, only representing a small portion of the business "gross receipts", but the costs involved in clipping bearer dividends is, if anything, negligible.

2.4. Whereas the deductibility of income production costs benefits both individual and corporate taxpayers, the deductions or allowances discussed in the next two sections are only conceivable with respect to the individual inocme tax.

## 3. THE BASIC PERSONAL EXEMPTION

3.1. Income tax law usually grants the deductibility of a given portion of income which is assumed to meet basic necessities of life. Such basic personal deduction, however, can be devised according to two different formulas, with differing rationales. In the first case in the English-language literature often called the "initial deduction"— the relief is granted only insofar as the taxable income does not exceed a given basic deduction level. If the deduction amounts to 100 U(nits), for example, the taxpayer with an income exceeding 100 U would become taxable. To the other type of basic deduction, the so-called "continuing deductions", [5] all incomes, whatever their level, are eligible. Thus, the taxpayer with net "produced" income of 1000 U remains taxable on 900 U, and the taxpayer with 5000 U, on 4900 U. In other words, the first slice of net income is subject to a zero tax rate, whatever the level of the taxpayer's total income. The progressive rate structure, so to say, is scaled down by one bracket.

3.2. *The Initial Deduction.* The initial deduction clearly aims at exempting incomes that are below a given "cut-off point". Such deduction may be explained on two grounds. One would be mere administrative convenience. The Fisc may not be interested in catching small fry. The other rationale is, obviously, more compelling. It would be socially and ethically repulsive, and economically counter-productive, as well, if the tax would bite into the limited purchasing power of a taxpayer whose income is inadequate to meet his most basic subsistence needs. Below the cut-off point, he is not supposed to have "ability (or capacity) to pay taxes". The initial deduction is designed to absolve the "poor" and, at any rate, the poorest from income taxation (whether the exemption level really corresponds to outlays for the taxpayer's basic needs, however, is highly debatable).

3.3 *The Continuing Basic Deduction.* The continuing deduction, on the other hand, derives from a somewhat different philosophy. The 2000 U income-recipient cannot be said to lack, as such, capacity to pay taxes; imposing tax on 2000 U instead of 1900 U would probably not significantly affect his tax liability. But even with respect to the comparatively "rich", only "excess income" above a basic allowance (which is supposed to represent outlays for essential needs) is held taxable. In other words, capacity to pay is determined by excess income. The intention is that only "really spendable income" [6] should be taxed, and not total income. In

4. *Sylvain R.F. Plasschaert*, "First Principles ...", cit.
5. Cf. *Michael E. Levy*, "Income Tax Exemptions. An Analysis of the Effects of Personal Exemptions on the Income Tax Structure", North Holland Publishing Company, Amsterdam 1960. In the German literature following *Karl Bräuer*, in "Ertragsteuern", Handbuch der Finanzwissenschaft, Tübingen, 1927, Vol II, p. 77 ff., the corresponding terms "Grenzminimum" and "Abzugsminimum" have been generally accepted.
6. We have purposely avoided the expression "disposable income", which, in economic writings, usually denotes income-after-taxes. Fiscal theory rightly holds that income taxes should not be deducted, although they reduce the directly spendable income, as they are regarded as counterparts of the benefits of public expenditures. Such deduction would greatly distort the intended statutory rate structure. For a quantitative example of such distortions see the author's contribution to "Senegal: Tradition, Diversification and Economic Development", World Bank 1975, p. 249 ff. Co-ordinating Author *Heinz B. Bachmann*. In federal countries, the deduction of lower-level income taxes from the centrally levied taxes is justified, however.

defining the taxable base, one takes into account not only, positively, income produced but also, negatively, that portion of income that is unavoidably consumed for basic needs.

3.4. *Conformity test.* The *initial deduction* should be granted, irrespective of the form of the income tax. But in a schedular system, this can only be done at the cost of some distortions between the taxpayers. Suppose that only one schedule carries the initial deduction - say, the schedule of labor incomes, both dependent and self-employed - an example of which is the professional tax in Portugal. [7] This approach allows one to grant the benefit of the initial deduction to a potentially large number of taxpayers, since most people are gainfully employed. But the minority of people, who derive only income, say, of a minimal amount from capital, would then be taxed, although they are perhaps desperately poor. If the basic initial deduction were granted in all schedules, some taxpayers with the same total income, might benefit more, if they derive income beyond the cut-off point from different sources, than those who rely on only one source. Such cases of discrimination, however, would be rather rare, considering the high concentration of capital income in high-bracket taxpayers. Note, however, that it is almost inconceivable to implement a basic initial deduction with respect to capital incomes which are usually taxed at the source. Such taxation is principally effected in an impersonal way and at irregular times, i.e. when the taxpayers cash their dividend or interest coupons.

3.5. In global systems, the initial deduction would pose no structural problem whatsoever. Initial deductions appear to be rather rare in global income taxes (e.g. Belgium), since the *continuing deduction*, and its "ability-to-pay" connotation, appears more suited to global income taxes. Here again, the insertion of the deduction of the continuing type in a schedular tax, either in one or in several taxes of the schedular set, would entail some distortions between taxpayers, depending on the composition of their total income. Several countries, however, have been led to insert a continuing deduction in the schedule on labor income. As already indicated, such an approach allows one to grant the deduction once, and only once, to the vast majority of taxpayers who obtain income solely from their labor inputs. South Korea is a case in point. Although the rates on real estate income are graduated, no basic deduction is accorded. Dividend and interest income, subject to a 20 percent withholding tax, are equally devoid of basic deductions. Business income and wages-salaries, on the other hand, benefit from a (continuing-type) basic deduction. [8]

## 4. DEPENDENTS' DEDUCTIONS

4.1. The basic personal deduction relates to a single person. Income recipients usually do not live alone, however, but are members of a household, consisting of the head of household, the spouse and possibly one or more children, and perhaps even parents. As consumption theory rightly stresses, the household is the fundamental economic unit. Income flows to the common purse from the labor inputs or assets of one or more members of the household; and togetherness under a common roof provides some "scale economies of consumption", as outlays per capita for lodging, food, etc. are thereby reduced.

4.2. The income tax law is also led to recognize the household. In several legislations, income accruing to the wife (and other dependents) is aggregated with that of the head of household; hence, total household income is the taxable object, or, stated otherwise, the household is considered as the taxable unit. This aspect, however, is not dealt with in the present paper.

4.3. It would hurt accepted views about tax justice if the bachelor were to benefit from the same basic deduction as a married couple without children, or, *a fortiori*, as a couple with 8 children. Hence, the fairly general practice of providing, in tax laws, for deductions on account of the number of dependents. (For our purposes, we may disregard the distinction between the marital deduction granted on account of the spouse, and the children's allowances, as their rationale is identical.)

4.4. Statutory provisions which grant relief on account of the size and the composition of the household in essence extend the principle of taxing only "excess income". This criterion should be applied not only to the bachelor, but, *a fortiori*, to the household, by providing appropriate deductions for the various dependents supported by the same amount of income accruing to the household. In a large family, a fairly substantial part of the income is, of necessity, earmarked for the essential needs of the members.

4.5. The canon of "horizontal equity" provides a related justification for the dependents' deductions. As Shoup puts it: "[there should be]... equal treatment of those equally circumstanced" and "almost equal treatment of those almost equally circumstanced". [9] Other things — such as family income, — being equal, it is obvious that the standard of living per capita in an 8-child household is inferior to that of childless spouses. The dependents' deduction goes some way to restoring the equality in spendable income between bachelors and households, and between households of different sizes.

4.6. *Conflicts with Other Goals*. Deductions for children and dependents are consonant with the usual views on tax equity. But they may conflict with the objective to stem the tide of rapid demographic growth. An increasing number of developing countries are committed to reducting the birth rate. A large panoply of instruments is thereby used, varying from sterilization (India) to social pressure (The People's Republic of China). Some countries, such as Singapore, have drastically reduced the tax deductions for children. The equity-motivated deductions for children indeed clash with the birth control goals of the government. The pace of generating children, a basic urge of mankind,

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7. "A Brief Tax and Trade Guide - Portugal", *Arthur Andersen and Co.*, 1972.

8. "Information Guide, January 1974, for Doing Business in Korea", *Price Waterhouse and Co.*

9. *Carl S. Shoup*, "Public Finance", Aldine Publishing Co., Chicago, 1969, p.23.

however, appears only marginally amenable to manipulation through financial instruments, such as tax deductions or outright subsidies.

4.7. *Techniques.* Various techniques may be used towards this end. Frequently a given fixed sum (an "allowance") is deducted from net produced income; this allowance often is differentiated amongst the spouse and the children; or, amongst the latter, according to their age, in an attempt to refine even further the horizontal equity standard. Apart from allowances proper, other techniques are used. Results in the same direction can be achieved when "a credit against tax" is granted, per dependent; or according to the "family quotient" technique, first introduced in France in 1948 and also in use in several former French colonies. The two latter mechanisms may be illustrated by the Senegalese system. A couple with two children enjoys a quotient, amounting to 3, for purposes of the global complementary tax (*"impôt général sur le revenu"*). This means that if total taxable income is 600,000 local units, tax liability amounts to three times the tax due on one third of the taxable base, or three times the tax on 200,000 U. Under progressive rates, the tax relief thus obtained may be quite substantial. [10] Besides, in the schedular tax on industrial and commercial profits (*"impôt sur les bénéfices industriels et commerciaux"*), relief is granted in the form of a "credit against tax", but only for children, 10 percent for the first, 20 percent for the second, and 30 percent for the third; the deductible amounts, however, are limited. [11] The choice of those techniques may not be a matter of indifference to given taxpayers, depending on the actual parameters involved, but they all are instrumental in implementing the same principle, viz. to even out tax liabilities of different households, in terms of their size and composition.

4.8. *The Conformity Test.* Predictably, our findings are identical to those with respect to the basic personal allowance. The dependents' deductions, indeed, are nothing less than an extension of the basic deduction to other members of the household. Schedular taxes do no not lend themselves to a rational implementation of deductions for dependents. That in actual schedular taxes such deductions tend to be given frequently in the schedule (or schedules that govern) employment income shows that the fiscal acknowledgement of family burdens has become a compelling feature of modern income taxes, on eminent equity grounds. Yet such insertion in a schedular tax remains "a second best" solution. Unjustified discriminations remain between taxpayers and depend on the relative importance of the various types of income. The proper way of rationally implementing dependents' deductions is with respect to total income, i.e. within a global income tax frame.

## 5. PRIVILEGED PERSONAL DEDUCTIONS

5.1. The principle of horizontal equity provides a strong argument to shape further differentiations in tax liabilities among otherwise similarly circumstanced households. As a matter of fact, a given household budget may be burdened with some unavoidable outlays that are exceptional or abnormal in terms of their occurrence and their importance. Such extra outlays to the same extent reduce the freely spendable income of that household, and, in the same vein, its "ability-to-pay-taxes" — certainly as compared to other households. Potentially, the horizontal equity criterion could be stretched and refined to quite an extent. As a matter of fact, attention can be focused to various subcategories of taxpayers - such as disabled persons who need care to move around, elderly people, or taxpayers shouldering high college fees for their children. Such deductions for high, differential burdens have been called by Groves "privileged personal deductions". [12] This expression connotes, on the normative level, that, to be justifiable, these cases should present solid merits. It may also suggest that their recognition in the tax statute may have been the result of successful lobbying by the groups concerned.

5.2. Space constraints allow neither an exhaustive list of such privileged personal deductions in various tax statutes, nor a detailed discussion of the merits of each of them. To convey the main thrust of our argument; we list, by way of example, those that are part of the income tax systems of the United States and of Colombia. These are countries with a global type of income taxation. In the United States, the list of these privileged personal deductions is fairly long and comprises the following item: (a) interest paid, (b) medical expenses, (c) philanthropic contributions, (d) some taxes paid (but not the federal income tax), (e) child-care for the working mother, (f) uninsured casualty losses, (g) contributions to political candidates (since 1971) and (h) miscellaneous items. In lieu of the itemization procedure the taxpayer may opt for a standard deduction. The deductibility of several of those items is constrained by maximum ceilings. [13]

5.3. Colombia allows privileged personal deductions for (a) medical expenses, (b) educational expenses, (c) rental payments for residences and (d) part of the payments made to professional people, other than physicians - such as lawyer's fees. Here equally, ceilings apply. [14]

5.4. One should notice that some of them, in our view, do not fit the underlying rationale of privileged personal deductions, discussed above. The deduction privilege for philanthropic contributions, for example, clearly aims at stimulating such donations and clearly belongs to the

10. This technique is similar to the "splitting system", introduced in the United States in 1948 and whereby, for tax purposes, the aggregate income of husband and wife is divided by two, as if each spouse were contributing equally to the household's income.
11. "Senegal: Tradition, Diversification and Economic Development", cit. p. 195 and 201.
12. *Harold M. Groves*, "Financing Government", third edition: New York, 1950.
13. See *Richard Goode*, "The Individual Income Tax", cit., Ch. VII, for a more detailed analysis. In 1970, the various types of privileged deductions represented not less than 16.8 percent of net produced income (p. 146).
14. See *Richard Musgrave and Malcolm Gilles*, "Fiscal Reform for Colombia", cit. The privileged personal deduction represented about 25 percent of net produced income in the mid-sixties, as based on a sample of Bogota taxpayers.

next group of deductions. While admittedly the ability-to-pay of the working mother is impaired when she has to arrange for child-care during her absence at work, such deduction can also be viewed as a "production cost", incurred in earning income. The "purest" example of the above deductions probably relates to medical expenses, provided, as in U.S. law, that they reach rather sizeable amounts and to the extent they are not adequately covered through the systems of social security.

5.5. *The Conformity Test.* The privileged personal deductions are given with respect to outlays that put a burden on total income, not on a particular type of receipt. Hence, they should be systematized in tax statutes after total income, net of production costs and of the basic and dependents' deductions, has been determined. There is another, technical reason why they should relate to total income. As already indicated, several items are only deductible to the extent they do not exceed a given percentage of total income. Here again, and quite justifiably, the reference is to global income.

5.6. Hence it should not come as a surprise that actual schedular taxes do not contain many such privileged personal deductions. In Portugal, the professional tax ("*imposto profissional*"), to which both self-employed and dependent incomes are subject, provides an allowance for medical expenditures. The other schedular taxes, e.g. those on real estate income and on "passive income" (= from capital), do not contain privileged personal deductions of the type discussed here, but carry a number of exemptions from gross income. In the global complementary tax, on the other hand ("*imposto complementar*"), apart from basic and dependents' allowances, charitable donations are eligible, within limits, for deduction. In a previous study, which also covered the previous "mixed" systems in Italy and Belgium, a similar dichotomy between the set of schedular taxes and the global complementary tax was also ascertained — thus confirming the tax design implications of rational schedular and global systems, discussed in this section. [15]

## 6. REALLOCATIVE OR INCENTIVE DEDUCTIONS

6.1. Tax statutes usually also comprise other deductions whose purpose is not to refine further the "ability-to-pay" yardstick in its horizontal dimensions, but are designed to influence the allocation of spendable income, in such a way that, as it is hoped, the taxpayer channels the use of his income to meritorious economic activities or to specific saving instruments or consumption items.

6.2. The list of such incentive or reallocative deductions (or of exemptions, if the relief is technically construed as a non-taxable gross receipt) is quite long. Almost all countries, even high income ones, have enacted a set of tax favors to induce domestic and foreign direct investment, which is usually called "incentive legislation" and which, naturally, mainly benefits the business sector. The techniques used are various: profits in the initial years may be exempted ("tax holiday"), or the taxable base may be reduced by schemes of accelerated depreciation of fixed assets or by "investment allowances". In the latter, the cost of investments can be deducted wholly or partially from taxable profits.

6.3. On the surface, at least, the deductions granted are considered worthwhile by the legislature, as they are intended to deflect the allocation of resources into preferred channels. A positive impact on economic efficiency and faster growth is thereby intended. In other cases, such as charitable contributions, social objectives are pursued. As against such positive effects, one must weigh three negative consequences. First, revenue is lost for the government; this fiscal effect, however, should be considered on a net basis, while taking into account the tax revenue which the new investments, possibly triggered by the tax relief, entail. Second, with respect to individual taxpayers, the deductions imply a distortion in the distribution of the income tax burden among different taxpaying units, in terms of the relative "ability-to-pay" principle. This point is further investigated in Sec. 7. Finally, the selective character of the incentives implies a lapse from the neutrality canon in public finance, which holds, in conformity with welfare theory, that, in competitive conditions, welfare is maximized when consumer sovereignty in the disposal of his income is respected. [16]

6.4. Whether the intended allocative impact of the incentive really occurs and offsets the sacrifice in terms of revenue, equity and neutrality, is basically an empirical question. Various studies have evaluated the effectiveness of incentive legislation. One difficulty in the assessment is that two effects of incentive deductions, their "income" and "substitution" effects, cannot easily be separated. An enlarged spendable income may induce more of the preferred activities, such as charitable contributions if the latter are highly income elastic. But larger donations will normally be due more to the fact that the deduction lowers the cost of the charity. If the marginal rate for a given taxpayer happens to be 50 percent, the donation is subsidized, by half. The lower cost may be expected, in some cases at least, to induce the taxpayer more towards donations as against other possible uses of income. Similar remarks can be made as regards investment and saving decisions. The "substitution effect" is, in fact, the one intended by the

15. *Sylvain Plasschaert*, "Cedulaire, Globale en Gemengde Types van Inkomstenbelastingen", Uystpruyst, Leuven 1964, p. 98-102.

16. One encounters here the theorem of the "excess burden". While this theory has been extensively covered in Public Finance handbooks, one must wonder, whether, in practice, it is really that important. First, the "extra burden" is evaluated with reference to an ideal world of Pareto optimality, which, in actual life, is utterly unattainable. Second, genuinely comprehensive taxes, whether on income or spendings, cannot easily be achieved in the real world. The excess burden can, therefore, be taken in stride, if other worthwhile economic and social objectives must be pursued by way of non-uniform taxes. The discussion in Sec. 6 is a case in point. For an authoritative discussion of the "excess burden", see *Richard A. Musgrave*, "The Theory of Public Finance. A Study in Public Economy", Mc Graw Hill, New York-Toronto-London 1959, p. 140-159.

legislature, as, to achieve an income effect, he could, without discriminating between taxpayers, effect an across-the-board reduction of tax rates. [17] Besides, to arrive at conclusive answers, one would have to compare the results in the situation *cum*-incentive provisions with what would have happened in the absence of the tax relief. This amounts, fundamentally, to investigating whether the incentive really triggered the investment decisions, a difficult undertaking, since multiple factors affect the propensity to invest (or save). Furthermore, such propensities differ among social groups and individuals.

6.5. Studies about the effectiveness of tax incentives remain, on the whole, rather inconclusive. The general tenor, however, appears to be that the effect of incentives should not be overrated. [18] In the realm of foreign direct investment, clearly, there are countries, e.g. Belgium, Singapore or other East Asian countries, which have offered generous tax favors to foreign investors and attracted large amounts of direct investments, indeed. It would be hazardous, however, to infer a causal relationship from any positive correlation between tax relief and additional investments. Other factors, such as a large domestic market, export facilities, comparatively low labor costs per unit of output and, more generally, a "favorable investment climate" appear to be of more significance, as suggested in various studies on direct foreign investment which were based on questionnaires. [19] Two other factors reduce, in several cases, the effectiveness of incentive deductions. First, countries tend to compete with each other, even within the same customs unions area, in the provision of tax favors. In such circumstances the tax favors obtained become a "windfall profit", for the enterprise, with little impact on the decision to invest — except perhaps in the preferred country. Secondly, a large number of developing countries do have a rather ambivalent, "love-hate" attitude towards foreign direct investments as carried out by multinational enterprises. Lavish tax incentives are on the books; but other stances, such as constraints on profit remittances, red tape and compulsory indigenization of management posts, create a rather unfavorable "investment climate". The benefits from tax incentives, then, are largely offset by other measures. As little investment occurs, the incentive laws are bound to be of little practical importance and to remain largely nominal.

6.6. *The Conformity Test.* In *a global* income tax, incentive deductions conflict with the aim to distribute the income tax burdens according to the ability-to-pay of each taxpaying unit. In strict logic, the taxable base of global income taxes should correspond to gross statutory income (net of statutory exemptions) *minus* the various deductions discussed in the previous sections of this paper.

6.7. In schedular taxes, incentive features appear to provoke fewer distortions. One reason is that in each schedular tax the taxable basis consists of a given type of income; an "incentive" deduction only reduces the burden on that type of receipt. Another reason is that schedular taxes, if rationally designed, should carry proportional rates. A percentage deduction amounts to a reduction in the tax rate, which does not benefit proportionally the rich more than the poorer taxpayer. Deductions, on incentive grounds, would then conflict with the set of flat rates established for the various separate schedular taxes. But it is not always possible to recognize a coherent set of rates in the actual schedular taxes which, if the basic principles of a schedular system are consistently adhered to, are differentiated according to the so-called "qualitative discrimination" doctrine. The latter holds that labor incomes should be treated more leniently than incomes from capital. (One may add that an incentive impact may also be achieved if, instead of granting deductions in a given schedule, that type of income is exempted or subjected to a deliberately preferential rate.)

## 7. THE REVENUE IMPACT OF DEDUCTIONS AND THE EROSION OF THE TAXABLE BASE

7.1. *Per Taxpayer.* The "tax saving", in absolute terms, which a taxpayer obtains when benefitting from deductions equals the product of the deduction times the applicable rate to the sum deducted. In a schedular system with flat rates, the richer income recipient will obtain a higher tax relief, in absolute and relative terms, if (a) the schedule in which the deduction or exemption is granted happens to carry a higher rate than other schedules, and (b) income from the taxwise preferred schedule is highly concentrated in the upper deciles of the income distribution scale — as is typically the case with capital income. Under progressive rates, and in the simpler case in which the sum deducted does not bring taxable income into a lower bracket of taxable income, the absolute tax relief is the product of the deduction times the marginal rate, applicable at the relevant level of taxable income. The upper income recipient at a 60 percent marginal rate enjoys a higher tax saving in absolute terms than the 20 percent marginal-rate taxpayer. It follows that, if, on the normative level, a given deduction cannot be justified, the nominal structure of progressive rates is distorted; the average rate which the taxpayer actually incurs may be substantially lowered, especially in the upper income ranges. [20]

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17. *Michael K. Taussig*, "Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions", National Tax Journal, 196 , I, p. 3.
18. Out of a large literature, see *George E. Lent*, "Tax Incentives for Investment on Developing Countries", International Monetary Fund Staff Papers, July 1967, p. 249-323. The findings on the effects of charitable contributions in the United States remain controversial. See *Richard Goode*, "The Individual Income Tax", cit., p. 160-68.
19. See, e.g. *D. Van den Bulcke*, "De Multinationale Onderneming. Een typologische Benadering", SVERG, Gent 1975, p.79-86. For Belgium tax relief ranked fairly high, presumably due to the fact that within a free-trading common market differential tax levels among member countries become comparatively more important than in an area with segmented national economies.
20. For a thorough analysis of measures of tax relief, other than the absolute value thereof, see *Michael E. Levy*, "Income Tax Exemptions", cit.

7.2. *In an Overall Sense.* Since the midfifties, various scholars in the United States have warned that the panoply of multifarious deductions substantially narrows the base on which taxes are ultimately levied. There is a large gap, indeed, between gross taxable income (or even "net produced income") and the net taxable income in the statute. Such "erosion" of the taxable base has remained the subject of intense debate in academic and political circles. Proposals are made, at times, to reduce drastically this erosion by disallowing or curtailing a great many deductions and exemptions.[21]

7.3. Data are available on the extent of tax erosion in the United States. For 1970, the various deductions, other than the costs of production, amounted to 34.3 percent of what we have called the "net produced income" (equivalent to what in American parlance is termed "Gross Adjusted Income"). One should add that the "net produced income" does not comprise items of imputed receipts which, if economists' views on the income definition were heeded, would have been included in gross taxable income.[22] The erosion of the base of the income tax is not restricted to the United States. The Musgrave team, on the basis of a sample of Bogota taxpayers, inferred that, for 1965, the deductions (in our terminology) scaled down the statutory net taxable base by not less than 57 percent of net produced income.[23]

7.4. The term "erosion" may carry a dual meaning. First, as a purely factual statement, it shows by how much successive layers of statutory deductions - i.e. without accounting for underreporting and evasion - narrow the taxable base on which the rates are ultimately applied; the "loss" of revenue to the fisc can equally be gauged. But on a more normative level, the terms "erosion" and "loss" usually carry a pejorative connotation. The inference is easily drawn that all or most exemptions and deductions, other than production costs, are not justifiable and should be repealed.

7.5. The literature on tax erosion rightly draws attention to the many "sieve-like" leakages in what, according to economic science, should be a much more comprehensive tax base. Such leakages also distort the distribution of tax burdens which is postulated by purposeful implementation of sound standards of equity. Furthermore, deductions (and even more exemptions) frequently introduce schedular elements and special rates on given types of income, thus undermining the comprehensive reach and the unitary character which the legislature has intended for a national income tax system.

7.6. Several critical remarks with respect to the otherwise excellent "erosion" literature may be ventured. Firstly, in some writings, the criterion or yardstick with which to evaluate the "unjustified" erosion is not clearly spelled out. Apart from the many difficulties in keeping a strict rein on the actual implementation of deductible income production costs, there can obviously be no question as to the need to provide for such deductions; this point is not disputed, indeed. The difficulty, and some of the confusion, starts with the other types of deduction. There are very sound arguments to allow several of them, especially the basic personal and related dependents' allowances. Even some of the privileged personal deductions can be defended on solid grounds. The proponents of a frontal attack on the erosion of the tax base rightly claim that the loss of taxable revenue is excessive; but apart from the political feasibility of plugging the revenue leakages, even in principle, the implicit wholesale condemnation of the deductions, which is sometimes uttered in more popularized writings, is not warranted. Hence, when the effects of the erosion on, for example, the average (effective) tax rate of the taxpayer are being discussed, one should clearly spell out the yardsticks of evaluation and the value judgments involved. The frequent statement that given deductions reduce the average rate of a, say, 20,000 U income-recipient from 50 percent to 30 percent, when measured against "net produced income" (in our terminology), may be mathematically exact, but it is not relevant for tax policy purposes. As a matter of fact, in terms of tax logic, the abolition of some major deductions, such as the personal and dependents' deductions, is not advisable. Neither is it politically palatable.

7.7. Besides, as indicated above, a global income tax system, predicated on the ability-to-pay principle, carries a substantial erosive potential. As discussed with respect to "privileged personal deductions", quite a few respectable cases can be shown in which a given subcategory of taxpayers is burdened by outlays for very worthwhile goods and services, which other taxpayers with the same net produced income do not experience. Hence, with respect to the discretionary "spendability" of income, these two subgroups are no longer similarly circumstanced and the ability-to-pay principle be further refined by additional deductions.

7.8. Furthermore, in our view, the claim that the erosion is largely due to efficient organized pressure of interest groups tends to be overrated. In several cases, e.g. with respect to the "depletion allowance" for mineral exploration, the pressure groups are visible or known to exercise a strong lobbying activity. But in other cases, as those discussed in Sec. 5, one does not easily visualize strongly-organized groups that achieve recognition of some of the personal deductions, such as those for medical expenses or child-care. The horizontal equity principle and the awareness that some segments of society may have special needs exhibits a lot of strength.

7.9. Fourthly, we did mention that in the schedular taxes there tends to be much less erosion on account of personal deductions. This finding is in line with expectations, as in ideal schedular systems the emphasis is on the production of incomes, not on its uses; in conformity with the ability-to-pay principle, this finding postulates that total spendable income, from whatever source derived, be brought within the tax base. But it was also

21. Two outstanding shcolars, Joseph Pechman and Stanley Surrey, have consistently advocated the need for a tax reform that would restore a genuinely comprehensive tax base.

22. See, *Richard Goode*, "The Individual Income Tax", cit., Table A-7, p. 306.

23. See *Musgrave and Gilles*, "Fiscal Reform for Colombia", cit., p. 37.

noticed that in actual schedular systems, there is a tendency to provide some "personalizing deductions", at least in the schedule of employment income. And since schedular taxes co-exist normally with a complementary global tax (within a so-called mixed frame), various personal deductions tend to be embodied in the latter. In fact, the point made here gives strong support to the arguments made in the two previous paragraphs. The "ability-to-pay" principle, which is inherent in the global system, is potentially erosive; and, yet, the horizontal equity dimension of the same principle cannot be overlooked on the political level, not even in countries with schedular (or mixed) systems, although such deductions do not quite meet the "conformity test" with respect to the schedular paradigm.

7.10. Fifthly, the claim that income tax rates could be reduced by drastically narrowing the scope of deductions invites some scepticism. Technically, the statement is beyond reproach. But, societies, even at high macroeconomic tax ratios, may be subject to the "Please effect", whereby new sources of revenue readily find new outlets for public expenditures. [24]

7.11. Finally, the above statements about the strength of the equity arguments in support of "personalizing" deductions do not apply to the "incentive" deductions. The latter may owe much more to pressure groups. But, although various empirical studies inspire scepticism about their effectiveness, some incentive deductions carry strong economic or social arguments which render a trade-off with the equity and revenue objectives less objectionable and even unavoidable.

## 8. SUMMARY AND CONCLUDING REMARKS

8.1. When designing an income tax law, once gross taxable income has been defined (more or less satisfactorily), steps must be taken to specify the statutory definition of net taxable income.

8.2. One obvious and essential measure consists in the deduction of the costs incurred to obtain each of the taxable gross receipts. Both schedular and global taxes provide for such deductibility.

8.3. Global taxes center on the comparative "ability-to-pay" of the various taxpaying units, i.e. mainly households. Taxes should not be imposed on a given sum which can be considered more or less to reflect the minimum outlays for subsistence. Even in a set of schedular taxes, minimum amounts of income are normally exempted, at least in the schedules that cover labor incomes. Administrative considerations may strengthen the case for such basic exemption.

8.4. In various circumstances ability-to-pay can be taken into account; among them, the idea that part of the income obtained must necessarily be channeled towards unavoidable and/or abnormally burdensome outlays. The persons belonging to the taxpaying unit should not be pushed below a minimum standard of living. Accordingly, the "basic deduction" and the "dependents' deductions" are normally provided. At least in global systems the tax legislator goes somewhat further and also allows deductions for other specified personal outlays (such as abnormally high medical outlays).

8.5. Such "personalizing" deductions cannot rationally, i.e. without causing distortions, be inserted in schedular taxes. They only make sense when they relate to the total income of the taxpayer. The very fact that in many schedular taxes some "personalizing" features have also been introduced proves how pervasive the "horizontal ability-to-pay" principle is. As in schedular taxes such deductions tend to be granted only in the labor income schedule, and as only a comparatively limited number of taxpaying units derive income from other sources — especially in developing countries — they greatly reduce the incongruity of "personalizing" deductions in schedular systems.

8.6. Deductions geared towards channeling the taxpayers' spendable income towards meritorious activities or items are widespread. The most conspicuous example consists of the so-called "incentive" laws to attract direct investment. Available evidence suggests that such incentives do not significantly enhance the investment flow; as a matter of fact, tax considerations are only one element in a complex net of determinants of investment behavior. Such deductions or exemptions can be inserted in a schedular set of taxes without serious distortions, as the schedular taxes are a collection of taxes on different receipts, at differentiated rates — although they conflict with the principle of "qualitative discrimination", according to which capital income must carry a higher burden than labor income of the same amount and which was a basic tenet of the schedular systems in their first stages of development, especially in France and Italy. In global taxes, such "incentive deductions" cause distortions in the distribution of the tax burden that would conform to strict equity yardsticks. But considerations of economic efficiency or social objectives may carry strong weight, if not in substance at least on the political level, and override equity considerations.

8.7. The "personalizing" and the incentive deductions under progressive rates (one characteristic of global income taxes) afford more tax relief, in absolute terms, for the high(er) income than the low(er) income recipient, thus distorting the burden of distribution which the legislature apparently intended when drawing a progressive tax formula.

8.8. The series of deductions under discussion in this paper narrow or "erode" the statutory taxable base and cause serious revenue leakages as compared with the situation in which the taxable base would strictly equal "net produced income". But some of the more popularized writings or interpretations of the - pejoratively viewed - "erosion" of the tax base invite serious reservations. Most importantly, there is a need to state clearly which norms the opponent of erosion wants to adopt. Value judgments appear unavoidable. Several of the "personalizing" deductions, anyhow, cannot possibly be discarded, considering the strength of the equity standard in income taxation. That principle has also penetrated the schedular layers of mixed systems, although to a typically lesser extent.

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24. *Stanley Please* , "Saving through Taxation. Reality or Mirage ?", Finance and Development, March 1967.

ECONOMIC COMMISSION FOR AFRICA:

# Eastern and Southern Sub-Regional Advanced Taxation Training Workshop

by I. A. Malik*

## I. INTRODUCTION

The United Nations Economic Commission for Africa conducted a highly successful pioneer Advanced Training Workshop in Tax Policy, Legislation and Administration for the Eastern and Southern Sub-Region of Africa at Lusaka from 12 August to 9 September 1977. This was done at the request of the Taxation Liaison Conference of the Sub-Region. The Workshop was attended by participants who are Senior Tax Officers from Botswana, Kenya, Lesotho, Tanzania and Zambia. The author of this article acted as Director of the Workshop for which discussion leaders and lecturers in specific fields were also provided by the United Nations Headquarters Centre for Transnational Corporations, the German Foundation for International Development, Commonwealth Fund for Technical Cooperation and the Income Tax Training Centre at Lusaka.

This Workshop was similar in character and coverage to one of the E.C.A. Regional Workshops held at Addis Ababa in October 1973 and which was financed out of bilateral assistance funds provided by the Royal Netherlands Government. In addition to such regional and sub-regional Taxation Training Workshops the E.C.A. during the past 6-7 years has carried out an extensive training programme in tax policy, legislation and administration for various countries in Africa at the local level.

The holding of the "Advanced Seminar on Current Problems and Training Needs in Tax Administration" which was held in Addis Ababa in December 1965 had in effect set the pace for this ambitious training programme. Apart from recommending that special attention be paid to the organisation of training programmes for African Tax Administrators this Conference had also recommended an Inventory of African Tax Laws. This Inventory was also issued in 1970 by the International Bureau of Fiscal Documentation, Amsterdam, under a special arrangement made with the Economic Commission for Africa.

*Curriculum of the Lusaka Workshop*

The Lusaka Workshop was quite extensive in its scope and coverage. It covered major topics ranging from Role and Problems of Fiscal Policy to various problems and intricacies of tax administration, tax incentives for industrial development, tax reform planning and scope for additional tax measures, codification of tax laws, techniques of revenue forecasting and various ways of taxing agricultural incomes in African developing countries.

The highlight of the Workshop was, however, the in-depth analysis and study through special syndicate work on problem areas of:— (a) the taxation of small traders particularly from the point of view of the feasibility and desirability of standardized presumptive assessment techniques; and (b) taxation of companies and multinational corporations with reference to tax avoidance practices and conclusion of double taxation agreements between developed and developing countries.

A brief resume of the deliberations of the Workshop on these two issues is presented below.

## II. TAXATION OF SMALL TRADERS

On the question of taxation of small traders the Workshop suggested the following two stages to be adopted:—

### A. Stage I

(a) To bring within the tax net the population of small traders and other categories of self-employed for identification purposes.

(b) When stage (a) has been achieved a distinct differentiation be made to eliminate those traders who were found to be liable for taxation from those that were non-liable.

In respect of (a) above the following lines of action were recommended:—

(i) Systematic special surveys should be conducted to determine whether the general level of business activities of the small traders in the area falls below or above the taxable limit. To strengthen the effectiveness of the survey proper transport facilities should be made available to each tax district.

(ii) Liaison with other agencies and local Government authorities. Tax authorities should establish and make full use of liaison arrangements with other Government agencies, including local Governments and District Development Committees.

* ECA Senior Regional Adviser, Budgeting and Financial Management Section.

(iii) Trading Associations and Marketing Boards should be approached directly to furnish the departments with information about the number of cooperative societies etc. operating in their area and other relevant information for tax purposes. They could supply the Taxation Department with all types of information on sale and purchase of goods, quantities received and disposed of and bonuses and commissions etc. received by traders. Here it has to be taken into consideration that there may be times of inconsistent turnover due to unpredictable economic factors.

(iv) Taxpayer education and publicity should be improved. One of the problems of tax departments dealing with the small traders is that:

(a) — they do not keep any records;
- most of them are illiterate and as a result, unfamiliar with tax laws;
- they do not appreciate their obligation to the State of meeting their tax liabilities.

(b) These factors call for the mounting of a tax consciousness compaign on all possible media of communication including use of:
- television and radio;
- newspapers and distribution of periodical pamphlets etc;
- associations such as Chambers of Commerce (Trading Associations), traders' seminars, training courses etc., educational institutions and village public meetings;
- use of government information services especially where political rallies or political conventions are held;
- it should be the duty of tax officers to be generally polite and educative in dealing with the taxpayers.

(v) The keeping of records should be stimulated. As most small traders do not keep records, or keep them in such a manner that proper accounts cannot be prepared from such records the tax authorities should resort to presumptive tax assessment techniques based on sample surveys, but this should be an interim measure rather than a permanent solution. It must be emphasised that presumptive assessments cannot be accepted for more than three years after which the small traders must submit proper returns and accounts.

Should any taxpayer dispute the standard presumptive assessments, he should be at liberty to submit a proper return supported by accounts.

(vi) Simplification of tax laws:
The easier the laws are to understand, the better they are complied with. It was suggested that the laws should be made simple but not simplified to the letter. It should be seen to that such simplification does not defeat the purpose for which the law was intended. People should be in a position to know what the law requires them to do. These requirements should be within the terms of the law for their benefit and understanding.

### B. Stage II

In this Stage non-liable taxpayers are distinguished from those that are liable. Some of the suggestions made to do this are as follows:—

(i) Determining the size of the business through periodical reviews and eliminating marginal cases and subjecting the liable cases to presumptive techniques.

(ii) Forcing the taxpayers by legal procedures to submit their tax returns.

(iii) A provision to be incorporated in the licensing regulations to the effect that no trader could be issued with a trading license without first producing a Tax Clearance Certificate from the Income Tax authorities.

(iv) Enforcement measures should be carried out. Distraint action should be instituted against small traders who default in paying their taxes. If necessary tax offices should be provided with adequate authority within the law to effect recovery even before going to the courts for legal action. It was strongly felt that in order to ensure perfect application of the relevant legislative provisions, the enforcement machinery must be competent enough, and it should be in a position to define, verify, impose and levy taxes for the purpose of assuring an equitable balance of taxes and achieving the objective of the taxation system.

(v) Proper training of local tax staff is a prerequisite for success of any scheme for effective taxation of small traders as they possess commanding insight into local conditions and culture.

(vi) Once the small traders who are not in the net are known to the tax department and then brought into the net action should be intensified to strengthen and streamline the tax department itself to deal with such cases under the regular income tax provisions on the basis of submission of accounts and returns.

## III. TAXATION OF COMPANIES AND MULTINATIONAL CORPORATIONS

In respect of the subject of taxation of companies and multinational corporations particularly with reference to tax avoidance practices and the conclusion of double taxation agreements between developed and developing countries the Workshop considered the following major aspects:—

(i) The need for adequate provisions in the domestic tax laws.

(ii) The ways the multinationals may seek to minimise their profits and possible steps to combat these devices.

(iii) The difference between the tax effects which may arise when operations are carried on in a developing country by a subsidiary and a branch respectively of a multinational.

(iv) The need to have a balanced approach in granting tax incentives to multinationals.

(v) The principles to be adopted by developing countries particularly as those negotiations may relate to the operations of multinationals.

(vi) The particular circumstances of special classes of companies e.g. (a) general insurance companies; (b) life insurance companies; (c) banks; (d) film renting companies; and (e) hotel operating companies.

On each of these aspects the Workshop considered as follows:—

### A. Need to have adequate domestic tax laws

The types of income or expenditure which generally pose tax problems in the context of being derived or incurred by multinationals from or in developing countries are:

(i) Business profits
(ii) Interest
(iii) Administrative expenses
(iv) Management fees
(v) Royalties
(vi) Know-how payments.

The following important aspects should be dealt with in the domestic tax laws of a developing country to meet problems in these areas:

(1) *Business profits*

The domestic tax laws should be so framed that business profits will be "*deemed*" to have a "*source*" in the developing county to the extent that they arise:

(i) from or through a branch or a permanent establishment in the developing country;
(ii) from a contract entered into or carried out in the developing country;
(iii) from the operations of a dependent agent in the developing country.

*Note:* It may be that a double tax agreement may later restrict the circumstances in which business profits are taxable in the developing country only to (i) above but it is considered that the domestic laws themselves should provide for business profits to have a source in the developing country in all three of (i), (ii) and (iii) above.

The domestic laws should also have provisions to apply an arm's-length test in calculating business profits when local operations are controlled from abroad, and goods are supplied from the parent office overseas to local operations.

(2) *Interest*

There are two aspects here which should be covered in the domestic tax laws of a developing country viz:

(a) Interest should be "*deemed*" to have a "*source*" in the country if the loan on which it is paid is used by the borrower (i.e. usually claimed as a deduction by the borrower) in the developing country irrespective of where the money has in fact been borrowed.
(b) Interest should be assessable at the *greater* of:
    (i) non-resident withholding tax on the *gross* interest;
    (ii) ordinary corporation tax rates on the net income from the interest if the payee is an associate of the payer.

Some countries have a definition of "associated persons" and in the context of companies, two companies would be associated persons if they were owned and/or controlled as to 50 percent or more by the same interest, or if one owned or controlled 50 percent or more of the other.

As regards (ii) above, in calculating the net interest, charges (such as interest the payee paid itself) would be deductible.

(3) *Administration expenses*

There may be no need to have specific domestic tax laws to control the deduction of administration expenses. However, they must be considered in relation to the general problem of multinationals and are mentioned here to distinguish them from management fees which are mentioned in (4) hereunder. Administration expenses in this context refer to the expenses applicable to administering the world wide operations of the particular group.

However, some thought should perhaps be given to limiting in the tax laws deduction for administration expenses to a set percentage of the gross receipts in the developing countries or giving the Tax Commissioner power to do so.

(4) *Management fees*

Management fees in this context refer to fees paid by say a "local" subsidiary to a parent company overseas for direct overall management of local operations. The significance of the difference between these fees and administration expenses is that there could be a legitimate profit element in the management fees paid by a subsidiary (but not by a branch) to a parent company but there should be no profit element in a reimbursement of administrative expenses whether paid by a subsidiary or a branch.

The domestic tax laws should have authority to deem a management fee paid by a subsidiary to its overseas parent to have a local source and be assessable at full corporation rates in the hands of the parent.

(5) *Royalties*

Here the domestic tax laws should provide:

(a) for royalties to have a "source" in the developing country when deducted by the payer in arrriving at the payer's assessable income in the developing country;
(b) the royalties when paid between "*associates*" to be assessable at the *greater* of:
    (i) non-resident withholding tax on the *gross* royalties;
    (ii) ordinary corporation rates on the net.

Some countries may allow a fixed ratio of expenses — say 33 1/3 percent in respect of (i) — unless the overseas payee can demonstrate a greater deduction is more appropriate.

(6) *"Know-how" payments*

It appears that some countries provide for three aspects in their domestic tax laws viz:

(i) to define what is meant by know-how payments, i.e. broadly payments for technical or commercial assistance, advice and formulae, etc.;
(ii) define when the payments have a "source" locally,

i.e. deducted by the payer in calculating the payer's income;

(iii) to assess to the payee the *greater* of non-resident withholding tax or corporation tax (as for royalties and interest) when paid between associates.

It is also necessary to determine as to the extent "know-how" is actually being transferred.

## B. The methods multinationals may use to minimize local profits and possible steps to combat them

(1) *Transfer pricing*

This, of course, is the most important and certainly the most difficult aspect of the whole subject of multinationals. It is largely a practical problem, namely of how to find and substitute an arm's-length notional price for the price that an overseas parent comany has charged its local subsidiary for goods it has supplied.
The problem can also have a marked effect on the balance of payment position and so full support for the Tax Department should be given by the central bank, trade and other like departments. Some tax officers should specialise in multinationals and if possible receive training in other countries where the problem has been considered in depth.

Overseas trade journals listing prices of or discounts of commodity prices and prices paid by independents may be useful tests but again the practical problem is to find these sources.

It may be possible to exchange useful information on the subject pursuant to double tax agreements. However, if the parent company is located in say one country to a double tax agreement and directly deals with its subsidiary located in the other country to the agreement the first mentioned country may not be very happy about supplying information on overpricing if in doing so it adversely affects its own tax revenues. The exchange of meaningful information is more likely to be forthcoming when the revenue of both countries has been adversely affected by companies interposed in a tax haven.

*Examples of tax haven techniques:*

*Case No. 1*

- A Ltd. is located in an African state
- It could sell in London for say £100 per article
- It forms a company in a tax haven and sells to it for £90 an article
- The interposed company then sells in London for the £100 and makes a £10 tax free profit

*Case No. 2*

- A Ltd. is the parent company located in America and would make a reasonable profit by selling to its subsidiary C Ltd. in Africa for $100 per article. However, it forms another subsidiary B Ltd. in a tax haven. It sells to B Ltd. for $90 and B Ltd. then sells to C Ltd. for $110. In this case both the American and African tax revenues have suffered and an exchange of information may be fruitful.
- Again the finding of transactions within tax havens poses practical problems but the "specialized" officers dealing with multinationals should be on their guard when they see sales or purchases made in what is obviously a tax haven.

(2) *Excessive charges for head office administration expenses:*

It may happen that an overseas company has branches or subsidiaries in various countries in the world and may seek to claim in a particular country a proportion of the head office or administration expenses (which in fact are incurred overseas) as being applicable to the operations carried on in that particular country. A claim of this nature is probably sound in principle but the question arises as to how to check that it is not excessive.

Some multinationals may merely claim and be allowed by the local tax administration a deduction for a proportion of head office administration expenses based on a percentage of the local gross receipts. At least at periodic intervals claims of this nature should be checked and the approach most favoured was to ask that a certificate by external auditors of the parent office be supplied giving the following details:
(i) an itemised list of the expenses included in the claim;
(ii) local receipts;
(iii) total receipts for the organizations as a whole.

The auditors' certificates would be required to certify that the expenses in (i) did not include any capital or other items not normally deductible for tax purposes and did in fact apply to administering operations of the kind carried on in the local country concerned.

The Workshop also considered an approach which would apportion administration expenses on the basis of the proportion that local expenses bear to total world expenses. However, as stated above it favoured on balance a deduction based on the proportion that (ii) above bears to (iii).

*Excessive claims for:*

- Interest
- Management fees
- Royalties
- Know-how payments

The Workshop considered that attempts by multinationals to minimize their local profits by excessive charges under any of these heads could best be met by adequate provisions in the local tax laws to assess the recipient through the agency of the local subsidiary company with the greater of:

- withholding tax on the gross payment
- ordinary corporation tax rates on the net income from the payment

Of course, obviously excessive claims could be adjusted by disallowance to the local payer.

### C. The differenct tax effects in relation to certain payments when local operations are carried on by a subsidiary and a branch respectively

A subsidiary is a different entity from its parent company but a branch is part of the same entity as its parent office.

Although some tax administrations may differ in their treatment of this matter, the Workshop favoured adopting the principle that when a branch and a parent office situation is involved, internal payments or credits between the branch and the parent office, should be ignored for tax purposes. The practical effect of this approach is as follows:

- Interest payable by the branch on its "Head Office Account" should neither be deducted by the payer nor assessable to the payee office. A portion of the interest payable to an outside lender may need to be allowed against the branch operations.
- Similarly internal payments or credits for royalties, "know-how" payments, management fees and the like should be challenged if they include a profit element but could be allowed if they represent the bare "cost" of providing those services to the branch.

### D. Tax incentives – the need for a balanced approach

The Workshop did not merely go into the ways multinationals may seek to minimize their local profits and therefore reduce the amounts of income tax they may pay to the local government concerned. But it did recommend as well that it could well be government policy to encourage multinationals to invest in or carry on development and other projects in the particular country, and in fact may give tax incentives for this purpose. The incentives may include any of the following:

- a tax holiday or reduced rates of tax for a specified period for income from a particular project;
- accelerated deduction for certain classes of capital expenditure;
- freedom from tax or reduced tax on interest or dividends from specified loans or investments in defined projects.

It has been suggested that some developing countries have been too hasty in granting tax incentives which in the short term at least can have an adverse effect on income tax revenues and the balance of payment position of a developing country. It may be also that multinationals may play one country off against another, to try and get ever increasing incentives. Taking into account these aspects the Workshop considered that careful thought should be given before incentives are extended – in fact that before giving incentives it must be clear that economic benefits which would not otherwise accrue will arise from them. There was also merit in "harmonization" of tax incentives in countries comprising the same economic area. Moreover the procedures of each government should provide for a mechanism for a review of the benefits to the developing country and regions, etc. so that a rational policy is followed in respect of incentives and unnecessary revenue losses are avoided.

### E. Principles to be adopted in double taxation agreements in relation to the types of income derived by multinationals from developing countries

The Workshop in view of time constraint could not consider this question adequately. However it identified the following broad principles involved. In double tax agreements and in negotiations leading up to them, income falls to be considered in relation to the country of its "source" and to the country of "residence" of the recipient of the income. The usual trend in a double tax agreement is to provide that certain classes of income are either to be wholly exempt in the country of "source" or are to be assessed at reduced rates of tax in the country of "source" (with consequent greater tax being payable in the country of "residence"). It would be extremely rare for the opposite to apply namely that income which was previously assessable only on a residence basis was now to be assessed on a source basis.

Most developing countries are unlikely to be faced with situations in which their own nationals have greater income from sources in another country than the nationals of that other country have from sources in their own. This being so, it would seem to follow that a developing country will tend to lose if the trend is to move income from being assessable on a "source" to a "residence" basis. In short, developing countries should therefore tend to hold the "source" line as far as possible in double tax negotiations.

### F. Special types of multinationals

Again, time constraints allowed only a cursory look at the particular problems associated with income derived from developing countries by such international organizations as:

- general insurance companies
- life insurance companies
- banking companies
- shipping companies
- film renting companies
- tourist hotel companies.

We think that the problems that developing countries face in considering these types of organizations are complex requiring further research and preparation of guidelines for African countries. The Workshop therefore strongly recommended that the UNECA should continue work on these lines in collaboration with other international organizations, etc. and frequently convene meetings of selected African Fiscal Experts to adopt position in respect of tax treatment of such entities in the context of problems faced by African countries.

# CONFERENCE DIARY

## JULY 1978

*European Study Conferences Limited:* Direct Investment in the United Kingdom (subjects include taxation of companies, taxation of individuals, capital gains tax, development land tax, value added tax), London (United Kingdom), July 13 and 14 (English).

## SEPTEMBER 1978

*32nd Annual Congress of I.F.A.:* I. The Taxation of Extractive Industries; II. The Differences in the Tax Treatment between Local and Foreign Investors and the Effects of International Treaties. Sydney (Australia) September 17-23 (English, French, German, Spanish).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

*Deutsche Steuerjuristische Gesellschaft e.V.:* Die Grundprobleme der Personengesellschaft im Steuerrecht (Basic problems of a partnership in tax law), Vienna (Austria), September 28 and 29 (German).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (Seminar), Brussels (Belgium), November 7-8 (English).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Deutsche Steuerjuristische Gesellschaft e.V.: Classen-Kappelmann-Str. 24, 5000 Köln 41 (German Federal Republic).

Euroforum: Keizersgracht 534, Amsterdam (Netherlands).

European Study Conferences Limited: Kirby House, 31 High Street East, Uppingham, Rutland, Leics. LE15 9PY (U.K.).

Fenedex (Federation for the Netherlands Export): Bezuidenhoutseweg 76a, 2509 LK Den Haag (Netherlands).

Financial Times Ltd. Conference Organisation: Bracken House, 10 Cannon Street, London EC4P 4BY (U.K.).

Inter-American Centre of Tax Administrators: Apartado 215, Panamá 1 (Panama).

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

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

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

Seminar Services International: 21-23 Chilworth Street, London W2 3HW (U.K.); Passage Perdonnet 1, CH-1005 Lausanne (Switzerland).

# INDIA:
# Capital Gains Tax

by Kailash C. Khanna*

Capital gains were charged to tax in India for the first time by the Income-tax and Excess Profits Tax (Amendment) Act of 1947. The relevant provision of law taxed capital gains arising after the 31st March, 1946.

The levy was virtually abolished by the Finance Act of 1949 which confined the operation of the taxing provision to capital gains arising before the first day of April, 1948.

According to A.N. Iyer, the founder of Income-tax Reports, the idea of levying a tax on capital gains and the main scheme of taxation were taken from the American law on the subject although the Indian legislature adopted a simpler scheme of taxation.

The Finance Act of 1956 re-introduced the legal provision in wider terms so as to bring within capital gains "any profits or gains arising from the sale, exchange, relinquishment or transfer of a capital asset effected after 31st March, 1956". It follows that capital gains tax is leviable on capital gains arising if the transfer of the capital asset took place between

(i) 1st April, 1946 to 31st March, 1948;
(ii) 1st April, 1956 onwards.

Between 1st April, 1948 and 31st March, 1956, no capital gains tax was leviable in India.

The reasons for the re-imposition of the capital gains tax in 1956 and the broad outline of the tax are given in the Indian Finance Minister's Budget Speech of 1956. This was as follows:

> "It is necessary now to increase the coverage of taxation by reaching a class of incomes which has hitherto been kept out of the purview of the income taxation — I mean capital gains. Capital gains are an important factor in aggravating economic inequalities, and there is no justification for regarding capital gains as a species of income not liable to taxation. This is a lacuna in the tax system of most countries, a lacuna, one dare say, they will have to rectify in due course. For a developing country like ours, it is necessary to take early action as the implementation of our programmes is certain to create conditions in which the assets of all kinds will appreciate. It is only fair that the exchequer should get a proportion of those incomes when realised in the form of capital gains."
>
> "Dealing first with direct taxation, my first proposal is to impose a tax on capital gains made on or after the 1st April, 1956. As Hon'ble Members are aware, a tax on capital gains forms part of our existing Income-tax Act, but it was in operation only for a short period, that is, in respect of capital gains which arose during the period 1st April, 1946, to 31st March, 1948. In the present Bill, I have somewhat altered the existing provisions.
>
> (i) The definition of 'capital gains' remains unchanged, but some of the existing exemptions are proposed to be withdrawn. These are capital gains arising on transfers of property on compulsory acquisition, capital gains arising on distribution of assets on dissolution of partnerships or on liquidation of companies, capital gains arising on the sale of residential property possessed by the taxpayer for seven years, etc. Such gains will now be subjected to tax.
>
> (ii) Under the existing law, capital gains up to Rs. 15,000 are not subject to tax in the case of individuals. This limit is proposed to be reduced to Rs. 5,000 but an additional concession is proposed to be given to persons in the lower income groups in that no capital gains tax would be chargeable if the total income, including the capital gains, does not exceed Rs. 10,000.
>
> (iii) I am also considering some concession for small people making gains by the sale of small and medium sized houses.
>
> (iv) Under the existing law, capital gains are to be taxed on the basis of slab rates. This, however, bears no relation to the other income of the person making the gains. It is now proposed that the rate of tax to be charged on capital gains should be the income-tax rate applicable to the other taxable income of the assessee increased by one-third of the capital gains he makes in the relevant year.
>
> (v) Another important change is that the assessee has the option to have his gains worked out either on the basis of original cost or on the basis of its value on the 1st January, 1954."

The broad scheme of taxation of capital gains continued on the above lines except for occasional changes following recommendations of the Direct Taxes Enquiry Committee (see below) and representations from foreign investors. For instance, under Section 52(2) of the Income-tax Act, a taxpayer is deemed to have made capital gains if the consideration declared for the transfer of the capital asset is less than the fair market value as reduced by 15%. The Government of India and the Reserve Bank have been recently insisting on dilution of foreign shareholding so as to increase Indian participation in subsidiaries and branches of foreign-held companies. The dilution has been effected by the foreign investor disinvesting a part of the holding at prices approved by the Government of India. Since such price has invariably been less than the fair market value (sometimes the reduction has exceeded 15% of the fair market value), a proviso was added in 1974 to the effect

* Kailash C. Khanna & Co., Chartered Accountants, Calcutta, India.

that the value determined by the Central Government or the Reserve Bank of India shall not be questioned by the Taxing Authority.

The latest changes in capital gains taxation effected by the Finance (No. 2) Act of 1977 are again worthy of note. The reason given for these changes was stated by the Finance Minister in his speech of 17th June, 1977, as under:

> "It is my belief that the present structure of capital gains taxation stands in the way of adequate mobility of investable resources and perpetuates investment of low priority assets. In this view, I am proposing certain changes in our existing scheme of capital gains taxation."

The changes mentioned by the Finance Minister were incorporated in the Finance (No.2) Act of 1977 and form part of the current Indian tax law. One of the important amendments provides that if the sale proceeds of any asset are re-invested within six months for a minimum period of three years in equity shares, bank deposits or other approved securities, the capital gains arising as a result of the sale shall be exempt from tax. This virtually nullifies capital gains taxation in large sphere. It is, however, anticipated that this concession may be shortly withdrawn. The definition of long term capital asset was also modified.

## THE DIRECT TAXES ENQUIRY COMMITTEE ON CAPITAL GAINS (1971 Report, p. 73)

Under the existing law, gains arising from the transfer of short-term capital assets (assets held for a period of not more than 24 months) are treated like ordinary income and taxed at normal rates. However, gains arising from the transfer of capital assets other than short-term capital assets are in effect subject to tax at lower rates.

Preferential tax treatment to long-term capital gains is generally sought to be justified on the ground that they relate to genuine investments as distinct from speculative ones, and that such gains are in any case only illusory, being mainly due to the continuous decline in the value of money. Further, these gains, though realised in one year, are actually attributable to several years of ownership of the asset by the taxpayer.

On the other hand, those who oppose preferential tax treatment to long-term capital gains point out that these are just like any other income and equally add to the economic power of the recipient and should, therefore, be taxed accordingly. Nicholas Kaldor had observed that "so long as, and to the extent that, taxation is based on 'income', the only impartial concept of income is that which treats all realised gains equally". The Royal Commission on Taxation for Canada, which also considered this point, has made the following observations:

> "Although property gains are generally taxed at preferential rates in other countries, we have concluded that because taxable capacity depends on the amount of a receipt, and not at all on its source, equity required that all receipts, including property gains, should be taxed at full rates."
>
> "... Arguments have been advanced that a reduced rate of tax for the gain on long-term assets gives recognition to the fact that a gain when realised may represent a value that has accrued over a long period of time.
>
> We reject this line of reasoning. The phenomenon of a large amount of income being realized in one year after accruing for many years is not an unusual one ..."

Several persons who appeared before us stated that the existing tax treatment of long-term capital gains is proper and fair. Apart from mentioning the reasons stated above, they pointed out that such preferential treatment encourages savings and capital formation and is thus conducive to the growth of the country's economy. Others, however, expressed themselves strongly against it. They saw no justification for not treating all capital gains like other income. They thought that law has been unnecessarily complicated in this regard and there was scope for simplification.

We have carefully considered the matter. We are of the opinion that such gains should not be treated on a par with other income. Capital gains may be partly attributable to inflationary pressures and, in any case, represent income which has accrued over a period of time. We are, however, of the view that the qualifying period for which an asset is held to be eligible for such treatment should not be too short. The qualifying period for concessional treatment of gains from the long-term capital assets is 5 years in Finland and 10 years in Norway. For real property, the holding period is stated to be 3 years in Spain, 5 years in Austria and 10 years in Finland. In our country, the qualifying period of holding is 24 months only in all cases. Such a short period of holding encourages speculative deals instead of promoting capital formation and contributing to a healthy growth of the economy. We, therefore, recommend that concessional treatment of capital gains should apply only to capital assets held for more than five years. Accordingly, the definition of short-term capital asset will have to be changed.

### ERRATUM

Dans notre numéro 1978/2 l'article de Monsieur Jean-Loup Haÿ (2ème partie) paragraph IV (p. 67) premier alinéa doit être lu comme suit: Après avoir lentement cheminé de l'Exécutif au Législatif, le projet de loi présenté officiellement le 20 avril 1976. . .

# The 1978 Income Tax Changes in the Republic of South Africa

by Dr. Erwin Spiro

As announced by Senator O.P.F. Horwood, the Minister of Finance, on March 29, 1978, the aim of the budget is to construct a stronger economic force in the subcontinent, a viable power which will be able to withstand the onslaughts from wherever they may come. How will this be achieved in the field of income tax ?

## COMPANIES TAX

The Minister felt now the necessity to grant relief in respect of the tight cash flow position experienced by many companies. The surcharge on normal income tax payable by companies is accordingly to be reduced by 2.5 percentage points in respect of the years of assessment ending on or after April 1, 1978 and on or before March 31, 1979. This means that all companies earning income, excepting gold mining and diamond mining companies, will pay a five percent tax surcharge instead of 7.5 percent, while gold mining and diamond mining companies will pay a surcharge of 7.5 percent instead of 10 percent.

The 15 percent loan levy hitherto paid by all companies will, however, be imposed again for the years of assessment ending on or after April 1, 1978 and on or before March 31, 1979. But the Minister envisaged that the loan levy which in any case was repayable during February next year, that is in the ensuing financial year, could be refunded to companies on July 15 this year, this being a further measure to improve the cash flow of companies.

No rates were proposed for companies in respect of income obtained in South West Africa since this decision rested with the Administrator-General.

## PERSONAL INCOME TAX

Firstly, the Minister proposed here, too, that the ten percent loan levy imposed on individuals during the last two years, be imposed again for the year of assessment ending on February 28, 1979. But, as in the case of companies, he proposed an earlier repayment to individuals of the loan levy falling due for redemption in the ensuing financial year, viz. on July 15, 1978. In the view of the Minister this step would assist the individual taxpayer to improve his own cash flow position, especially in view of the imposition of the general sales tax of 4 percent on July 1, 1978.

Secondly, the Minister proposed that the full ten percent surcharge on normal tax on individuals should now be completely abolished. No surcharge will, therefore, be payable for the year of assessment ending on February 28, 1979. This step is aimed at creating a climate favourable to a higher level of economic activity.

According to the Minister, the abolition of the surcharge means that the maximum marginal tax rate will revert to 60 percent, a figure which found favour with the Franszen Commission a few years ago. It is true that the loan levy of 10 percent which is still payable is not a true tax because it is redeemable, but practically at least it is felt as a tax, and the maximal marginal tax rate may, therefore, well be regarded as being 66 percent.

As the Minister pointed out further, the abolition of the surcharge would also have a favourable influence on all marginal rates at which incremental incomes were taxed, a reduction in the marginal rates going a long way towards solving the question of the joint taxation of the husband's and the wife's incomes.

## FOREIGN EXCHANGE LOSSES

The Minister proposed the deduction from income of exchange losses on foreign financing for which no forward cover was available, such deduction to apply only if the losses originated from the repayment of credits utilized for domestic productive purposes in the commercial, industrial and mining fields. Profits realized in these circumstances would, of course, be dealt with as taxable income. These provisions would be operative from the 29th March, 1978 (the date of the Budget Speech).

## DONATIONS TAX

The coupling of donations tax with income tax derives from the object of the former to discourage taxpayers from parting with their income-bearing assets and thus reducing their liability for income tax (and, ultimately, for estate duty). But as the exemption for children had remained unchanged for more than 20 years, the exemption limit has now been raised to R 15,000 per child, the increased limit to be applied to donations made on or after April 1, 1978.

## STANDING COMMISSION ON TAX POLICY

The Minister referred again to the valuable research work of the Standing Commission on Tax Policy, particularly in connection with fringe benefits, tax expenditure, the effects of inflation on taxation, individual tax rates, incentive allowances, international taxation and the withholding tax. But no tangible results seem here to have materialized.

## RATES OF INCOME TAX (NORMAL TAX)

### Persons other than companies

Persons other than companies are, in respect of the taxable income derived in the years of assessment ending on February 28, 1979, or June 30, 1979, subject to the tax at the rates contained in the two tables annexed to this article. These tables are based on taxable amounts which are the amounts remaining after deducting from taxable income as defined the abatements applicable. Provided the tax is R150.00 or more, there is added a redeemable loan levy of 10 percent.

### Companies

The rates for companies in respect of taxable income derived in the Republic of South Africa for the year of assessment, that is the financial year ending during the twelve-month period from April 1, 1978, to March 31, 1979, are as follows:

(i) *taxable income derived otherwise than from mining:* 40 cents per R1. A surcharge of 5 percent of such tax and a loan portion of 15 percent thereof are to be added to such tax. The effective rate is thus 48 cents per R1.

(ii) *Taxable income derived from gold mining:*

(a) on any mine other than a post-1966 gold mine an amount determined in accordance with one of the formulae laid down plus a surcharge (which is not payable in respect of certain assisted gold mines) equal to 7½ percent of the said amount and a loan portion equal to 15 percent thereof;

(b) on post-1966 gold mines an amount determined in accordance with one of the formulae laid down plus a surcharge of 7½ percent of the said amount and a loan portion of 15 percent thereof;

(c) in the form of excess recoupments over capital expenditure accruing to companies which are or have been gold mining companies the average rate of tax as determined in accordance with the Act or 35 cents per R1 whichever is higher.

(iii) *taxable income derived from mining for diamonds*: 45 cents per R1 plus a surcharge of 7½ percent of such amount and a loan portion of 15 percent thereof.

(iv) *taxable income derived from mining operations other than mining for gold or diamonds (or natural oil)* : the position is the same as in the case of a non-mining company (see (i) above).

(v) *taxable income derived from mining for natural oil* : in respect of taxable income derived from mining for natural oil (excluding gas) normal tax at the rate applying to non-mining income plus an amount equal to 40 percent of the balance remaining after deducting the normal tax and in respect of taxable income derived from mining for natural oil in the form of gas normal tax at the rate applying to non-mining income, the normal and additional taxes chargeable being subject to such a reduction as the Minister of Mines, in consultation with the Minister of Finance, may determine. Where sulphur, salt or any other mineral is won in the course of mining for natural oil, the income derived from the mining of sulphur, salt or other mineral is deemed to be derived from mining for natural oil.

## RATES OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

### Non-resident shareholders' tax

The non-resident shareholders' tax is 15 percent of the amount of the dividend or interim dividend in question.

### Undistributed profits tax

The undistributed profits tax is 33 1/3 cents on every R1 by which the distributable income as defined exceeds the amount of dividends distributed during the specified period as defined.

### Non-residents' tax on interest

The non-residents' tax on interest is 10 percent on the amount of the interest in question.

### Donations tax

The donations tax is at progressive block rates, the block exceeding R 90,000.00 being taxable at the rate of 25 percent.

## ANNEXURES

**Table I**

| Taxable Amount | Rates of tax in respect of married persons |
|---|---|
| Where the taxable amount— | |
| does not exceed R1,000 | 9% of each R 1 of the taxable amount; |
| exceeds R 1,000 but does not exceed R 2,000 | R 90 plus 10% of the amount by which the taxable amount exceeds R 1,000; |
| exceeds R 2,000 but does not exceed R 3,000 | R 190 plus 10% of the amount by which the taxable amount exceeds R 2,000; |
| exceeds R 3,000 but does not exceed R 4,000 | R 290 plus 11% of the amount by which the taxable amount exceeds R 3,000; |
| exceeds R 4,000 but does not exceed R 5,000 | R 400 plus 12% of the amount by which the taxable amount exceeds R 4,000; |
| exceeds R 5,000 but does not exceed R 6,000 | R 520 plus 14% of the amount by which the taxable amount exceeds R 5,000; |
| exceeds R 6,000 but does not exceed R 7,000 | R 660 plus 16% of the amount by which the taxable amount exceeds R 6,000; |
| exceeds R 7,000 but does not exceed R 8,000 | R 820 plus 18% of the amount by which the taxable amount exceeds R 7,000; |
| exceeds R 8,000 but does not exceed R 9,000 | R1,000 plus 20% of the amount by which the taxable amount exceeds R 8,000; |
| exceeds R 9,000 but does not exceed R10,000 | R1,200 plus 22% of the amount by which the taxable amount exceeds R 9,000; |
| exceeds R10,000 but does not exceed R11,000 | R1,420 plus 24% of the amount by which the taxable amount exceeds R10,000; |
| exceeds R11,000 but does not exceed R12,000 | R1,660 plus 26% of the amount by which the taxable amount exceeds R11,000; |
| exceeds R12,000 but does not exceed R13,000 | R1,920 plus 28% of the amount by which the taxable amount exceeds R12,000; |
| exceeds R13,000 but does not exceed R14,000 | R2,200 plus 30% of the amount by which the taxable amount exceeds R13,000; |
| exceeds R14,000 but does not exceed R15,000 | R2,500 plus 32% of the amount by which the taxable amount exceeds R14,000; |
| exceeds R15,000 but does not exceed R16,000 | R2,820 plus 34% of the amount by which the taxable amount exceeds R15,000; |
| exceeds R16,000 but does not exceed R17,000 | R3,160 plus 36% of the amount by which the taxable amount exceeds R16,000; |
| exceeds R17,000 but does not exceed R18,000 | R3,520 plus 38% of the amount by which the taxable amount exceeds R17,000; |
| exceeds R18,000 but does not exceed R19,000 | R3,900 plus 40% of the amount by which the taxable amount exceeds R18,000; |
| exceeds R19,000 but does not exceed R20,000 | R4,300 plus 42% of the amount by which the taxable amount exceeds R19,000; |
| exceeds R20,000 but does not exceed R21,000 | R4,720 plus 44% of the amount by which the taxable amount exceeds R20,000; |
| exceeds R21,000 but does not exceed R22,000 | R5,160 plus 46% of the amount by which the taxable amount exceeds R21,000; |
| exceeds R22,000 but does not exceed R23,000 | R5,620 plus 48% of the amount by which the taxable amount exceeds R22,000; |
| exceeds R23,000 but does not exceed R24,000 | R6,100 plus 50% of the amount by which the taxable amount exceeds R23,000; |
| exceeds R24,000 but does not exceed R25,000 | R6,600 plus 52% of the amount by which the taxable amount exceeds R24,000; |
| exceeds R25,000 but does not exceed R26,000 | R7,120 plus 54% of the amount by which the taxable amount exceeds R25,000; |
| exceeds R26,000 but does not exceed R27,000 | R7,660 plus 56% of the amount by which the taxable amount exceeds R26,000; |
| exceeds R27,000 but does not exceed R28,000 | R8,220 plus 58% of the amount by which the taxable amount exceeds R27,000; |
| exceeds R28,000 | R8,800 plus 60% of the amount by which the taxable amount exceeds R28,000; |

**Table II**

| Taxable Amount | Rates of tax in respect of persons who are not married persons |
|---|---|
| Where the taxable amount— | |
| does not exceed R1,000 | 12% of each R1 of the taxable amount; |
| exceeds R 1,000 but does not exceed R 2,000 | R 120 plus 12% of the amount by which the taxable amount exceeds R 1,000; |
| exceeds R 2,000 but does not exceed R 3,000 | R 240 plus 13% of the amount by which the taxable amount exceeds R 2,000; |
| exceeds R 3,000 but does not exceed R 4,000 | R 370 plus 14% of the amount by which the taxable amount exceeds R 3,000; |
| exceeds R 4,000 but does not exceed R 5,000 | R 510 plus 17% of the amount by which the taxable amount exceeds R 4,000; |
| exceeds R 5,000 but does not exceed R 6,000 | R 680 plus 20% of the amount by which the taxable amount exceeds R 5,000; |
| exceeds R 6,000 but does not exceed R 7,000 | R 880 plus 23% of the amount by which the taxable amount exceeds R 6,000; |
| exceeds R 7,000 but does not exceed R 8,000 | R1,110 plus 26% of the amount by which the taxable amount exceeds R 7,000; |
| exceeds R 8,000 but does not exceed R 9,000 | R1,370 plus 28% of the amount by which the taxable amount exceeds R 8,000; |
| exceeds R 9,000 but does not exceed R10,000 | R1,650 plus 30% of the amount by which the taxable amount exceeds R 9,000; |
| exceeds R10,000 but does not exceed R11,000 | R1,950 plus 32% of the amount by which the taxable amount exceeds R10,000; |
| exceeds R11,000 but does no texceed R12,000 | R2,270 plus 34% of the amount by which the taxable amount exceeds R11,000; |
| exceeds R12,000 but does not exceed R13,000 | R2,610 plus 36% of the amount by which the taxable amount exceeds R12,000; |
| exceeds R13,000 but does not exceed R14,000 | R2,970 plus 38% of the amount by which the taxable amount exceeds R13,000; |
| exceeds R14,000 but does not exceed R15,000 | R3,350 plus 40% of the amount by which the taxable amount exceeds R14,000; |
| exceeds R15,000 but does not exceed R16,000 | R3,750 plus 42% of the amount by which the taxable amount exceeds R15,000; |
| exceeds R16,000 but does not exceed R17,000 | R4,170 plus 44% of the amount by which the taxable amount exceeds R16,000; |
| exceeds R17,000 but does not exceed R18,000 | R4,610 plus 46% of the amount by which the taxable amount exceeds R17,000; |
| exceeds R18,000 but does not exceed R19,000 | R5,070 plus 48% of the amount by which the taxable amount exceeds R18,000; |
| exceeds R19,000 but does not exceed R20,000 | R5,550 plus 50% of the amount by which the taxable amount exceeds R19,000; |
| exceeds R20,000 but does not exceed R21,000 | R6,050 plus 52% of the amount by which the taxable amount exceeds R20,000; |
| exceeds R21,000 but does no texceed R22,000 | R6,570 plus 54% of the amount by which the taxable amount exceeds R21,000; |
| exceeds R22,000 but does not exceed R23,000 | R7,110 plus 56% of the amount by which the taxable amount exceeds R22,000; |
| exceeds R23,000 but does not exceed R24,000 | R7,670 plus 58% of the amount by which the taxable amount exceeds R23,000; |
| exceeds R24,000 | R8,250 plus 60% of the amount by which the taxable amount exceeds R24,000; |

# NEW ZEALAND:

# A Guide to Non-Resident Withholding Tax*

The Tax Act imposes a withholding tax on certain classes of income derived from New Zealand sources by non-residents.

The term "non-resident" is not used as such in the Income Tax Act. It is a colloquial term term which is used to describe those persons (including companies) who do not come within the deeming provisions of section 241. Section 241 is the section which determines when a person is deemed to be a resident in New Zealand.

*Income subject to withholding tax*

The following classes of income are classified as non-resident withholding income and are subject to withholding tax—
— Dividends — other than investment society dividends or exempt dividends from capital profits.
— Interest or investment society dividends.
— Royalties or other like payments.
— "Know-how" payments.

Non-resident withholding tax is deductible from gross dividends, interest and royalties including cultural royalties. The term "gross" means without any deduction whatsoever. The tax is final in the case of dividends and cultural royalties. It is also final on interest except when the payer and payee are associated persons. (See intereest on page 10.) Additional tax will be payable on royalties other than cultural royalties and "know-how" payments if the income tax assessed on the net income after deducting expenses exceeds the withholding tax.

*Income exempt from withholding tax*

The following classes of income are exempt from non-resident withholding tax—
— Income which is exempt from ordinary income tax.
— Income derived by companies from the carrying on in New Zealand of the business of life insurance and assessable under section 204.
— Interest derived by a non-resident investment company from any undertaking, scheme or work declared by Order in Council to be a "development project".
— Income derived from film hire.
— Interest derived from stock or debentures issued by the New Zealand Government, or a local or public authority, the interest on which is payable out of New Zealand.
— Interest derived from loans, the interest on which is exempt under an agreement or arrangement made with the New Zealand Government.

* From Public Information Bulletin No. 92 of December 1977.

[continued on p. 229]

# UNITED KINGDOM:

# Mr. Healy's 1978-79 Budget*

On April 11, 1978 the Chancellor of the Exchequer, Mr. Denis Healy, pronounced his Budget Speech in which he promised cuts in income tax worth close to £ 2 bn, with the aim of encouraging a level of economic activity sufficient to get unemployment moving significantly down.
With respect to taxation the Chancellor, inter alia, said:

A major purpose of the Budget is to adjust taxation so as to help and improve our industrial performance. Our business tax system is generally recognised as giving very generous incentives to new investment, and the scheme for stock relief which I introduced in 1974 has also been of immense value to industry.
I think the House would agree that what industry requires is stability in their tax environment. I have therefore decided again to make no major changes this year in the rate of Corporation Tax or in the levels of investment incentives.

### Inflation accounting

In my Budget statement last year I said the stock relief scheme would continue in its present form for 1977-78 and 1978-79. I then hoped that the debate on current cost accounting might by now have reached the stage where we could move to a permanent scheme of relief. But it is now clear that more time is needed for discussion of inflation accounting and, when an accounting standard has been agreed, tried and tested, for deciding how far it can be used for tax. I intend, therefore, to retain the present scheme for 1979-80, and to continue it indefinitely until a permanent scheme can be introduced.
However, I recognise there is a continuing concern about the build up of deferred tax liabilities in company accounts and the effect this may have on the raising of investment capital and investment decisions. This is a matter which can best be dealt with as a part of the permanent scheme. I wish, however, to dispel any anxiety among industrialists that with the present scheme continuing indefinitely they may be faced with a mounting volume of potential tax liabilities.
I, therefore, give this assurance now: if, this time next year, we are still unable to see what form a permanent scheme will take, we shall introduce legislation to limit the build up of these liabilities as follows.
First, the balance of the relief for the first two years of the scheme will be written off. Second, we shall build into the present scheme similar provisions for a write-off of so much of the relief for each subsequent year as remains after a six year period.
This will remove the major criticisms which industry has of the present arrangements and will enable stock relief to continue in more or less its present form until a permanent system is available.

### Income tax and small businesses

While overall stability is my main purpose so far as companies in general are concerned, I believe that so far as small businesses are concerned we can expect a significant improvement in industrial performance from some easing of the tax regime.
In my Statement last October, I announced the first changes which were proposed in the tax treatment of small firms and in particular a big increase in the CTT relief.
I can now outline the firm decisions we have made on the matters which were then under review.
First, I intend to raise the profits limit for the small companies rate of corporation tax from £40,000 to £50,000 and to increase the limit for marginal relief from £65,000 to £85,000.
Next I intend to provide that a business man who makes trading losses in the early years of an unincorporated business, will be able to set them against income received in previous years.
I also propose to give relief similar to that for employees last year to self-employed people and members of partnerships who are resident here and work abroad.
We are also proposing substantial relaxations in the capital gains tax rules for small businesses. I intend, as foreshadowed last October, that capital gains tax on gifts of business assets either within a family or to employees should be deferred until the assets are sold. This will be a major help in passing on a business.
In addition I propose that losses on loans and guarantees should henceforward qualify for capital gains tax relief. This will encourage investment in family companies.
Finally, I intend to raise the limit for retirement relief from its present level of £20,000 to £50,000. A very large increase is, I think, justified here to help the small business man who has worked hard all his life to build up a modestly successful business.

### VAT and small businesses

Finally, I am concerned to limit the burden of VAT on small firms. I am proposing to make a number of changes in the administration of the tax and, in particular, to raise the registration limit to £10,000 and to allow relief against VAT for bad debts in insolvencies.
I propose now, however, to give extra help to two particular sectors. First, farmers. I think it is generally accepted that farmers are in a unique position, partly because the weather can produce substantial fluctuations in their income and partly because farming is a highly capital intensive industry requiring substantial investment.

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* Extracts of Budget Speech 1978-79.

I have, therefore, decided to allow farmers to average their incomes for tax purposes when they vary by 30 percent or more between two years and to increase the agricultural building allowance in the first year to 30 percent.
Second, the hotel industry. In recent years a substantial increase in tourism has made an important contribution to our invisible export earnings.
I therefore propose that any expenditure incurred after today on the construction or extension of an hotel with at least ten bedrooms should qualify for capital allowances at the rate of 20 percent initial allowance and 4 percent annual allowance.

### Profit sharing encouraged

I also wish to encourage profit-sharing in this year's Finance Bill. Profit-sharing schemes can encourage the employees of a company to identify themselves more closely with their company. As the hon. Gentleman, the member for Cornwall North (Mr. John Pardoe), has often emphasized, this can help to improve the relationship between employees and employers, encourage greater efficiency and stimulate growth.
If it is not simply to give relief to the higher paid there must be a ceiling to the amount of relief to which any one taxpayer can be entitled. So there will be a limit of £500 a year to the value of shares which can be allocated tax free to any one employee.
My proposals will take effect from next year and will broadly follow Method III [1] as set out in the Inland Revenue's consultative document published last February.

### No indexation for capital gains

I have studied very carefully the representations which the Inland Revenue received on their consultative document on capital gains tax and inflation. [2]
I must conclude that the practical problems for taxpayers, their advisers and the Inland Revenue alike in any scheme for indexation or for tapering would be too great.
Moreover, I do not think it would be right to give relief for inflation to investors in shares and land, while investors in building societies and other fixed interest loans receive none — and while an investor can benefit from the decrease in the real value of his borrowings.
But to lighten the burden on small investors I propose that an individual's gain up to £1,000 in any year should be exempt and gains between £1,000 and £5,000 charged at 15 percent, that is, at half the full rate.
A marginal relief will secure that only large gains of £9,500 or more in a year will bear the full rate. These provisions will apply to the year just ended and will replace the present exemption for small disposals and the alternative basis of charge which many people have had difficulty in understanding.

### Tax avoidance: retrospective legislation

Lastly, tax avoidance. This has emerged recently in a new form which involves marketing a succession of highly artificial schemes — when one is detected, the next is immediately sold — and is accompanied by a level of secrecy which amounts almost to conspiracy to mislead.
The time has come not only to stop the particular schemes we know about but to ensure that no schemes of a similar nature can be marketed in future.
So the provisions I shall be introducing this year to deal with artificial avoidance by certain partnerships dealing in commodity futures will go back to April 6, 1976, that is, before the date when the intention to legislate was announced in a Parliamentary answer.
My proposed measures against avoidance by means of land sales with the right to re-purchase will go back to December 3, 1976, the date foreshadowed in a Parliamentary answer: and I will from to-day counteract devices for avoiding the CTT charges on discretionary trusts and avoidance of CTT through the use of associated endowment and term life policies.

### No increase in indirect taxes except for high tar cigarettes

I think it is now generally recognised that, while the total burden of taxation in Britain is well within the international average, the proportion of total revenue derived from income tax is still too high although I have already reduced it significantly in the last three years. Cuts in income tax will, therefore, account for almost all the £2.5bn. stimulus which I have announced.
I know that some MP's think it would be right to cut income tax this year by a much larger sum and offset the additional costs by increase in indirect taxation. In principle, I have some sympathy with this view.
But I believe that this year we must consolidate and reinforce our success in the fight against inflation so that we can for good and all bring down the inflationary expectations which have so damaged our economy in recent years.
In this situation I cannot believe it would make sense for the Government itself deliberately to raise the inflation rate and increase the cost of living. I will, therefore, leave the indirect taxes generally unchanged on this occasion — with one small exception.
To discourage the smoking of cigarettes which have a higher tar yield, I intend to introduce from September 4 a supplementary duty on cigarettes with a tar yield of 20 milligrammes or more. If the manufacturers fully passed on this increased duty in prices they would raise the price of 20 of these cigarettes by about 7p. About 15 percent of cigarettes will be affected.
The House will recognise that this supplementary duty is not design primarily to raise revenue — it could bring in only £25m. in a full year at most — and if it results in

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1. *Editor's note:* Method III entails a form of profit sharing along the following lines. A company would be permitted to make an allocation each year for profit sharing. The sum so allocated would be used to buy shares at full value. These shares would be apportioned between all employees in the company who were within the scheme, but the shares would be retained by a trust established for this purpose. The amount apportioned to each employee would not attract any Schedule E liability at this stage.
2. *Editor's note:* see 17 European Taxation 299 (No. 9 of 1977).

leading smokers to abandon these high tar cigarettes, no one will be more pleased than I.
The effect on the retail price index will be negligible.

### National insurance surcharge

I have also been asked to consider an increase in the National Insurance surcharge. The share of employer social security contributions and payroll taxes in total revenue is a good deal lower in Britain than in most other countries of the European Community.
But I do not believe it would be right to increase it so soon after it has been introduced, and at a time when unemployment is our major problem. It would increase industrial costs at a time when it is essential to improve our competitiveness and it would ultimately be largely passed on in higher prices at a time when the fight against inflation is at a crucial stage.

### Income tax and the familyman

The proposals I have announced so far leave £2.4bn. for reductions in income tax. I have considered carefully how they should be distributed so as to further the objectives I have set myself to increase the incentive for greater effort and to promote social justice.
I believe it is right to regard this Budget as the second phase in a process which I began last autumn. I told the House in October that, as well as increasing the plans for public expenditure in 1978-79, I was raising the level of the personal allowances fixed in last year's Finance Act by 12 percent, so as to ensure that their real value was maintained, and that I was bringing forward this increase in tax thresholds by 12 months compared with the date provided for in the Act.
In practice, this increase has turned out to be slightly higher than the increase in the retail price index over the calendar year 1977.
The question I have had to decide for this Budget is whether I should devote the bulk of the tax relief now available to raising the tax thresholds still further, or whether I should introduce a lower initial rate of tax.
Since I have already more than fulfilled my obligation to index tax thresholds, I have been particularly impressed by the argument that the rate at which people become liable to enter income tax is too high. It is indeed the highest in the world. It means that many of the low-paid are little better off in work than on the dole. I cannot believe that this makes sense in either economic or social terms.
I propose therefore to introduce a lower rate of tax at 25 percent on the first £750 of taxable income. This new lower rate will be the marginal rate of tax for some 4m. of the low paid. Most tax payers now caught in the poverty trap will find its impact that much less severe because their tax rate will be 9 per centage points lower than now.
Other taxpayers will be £1.30 a week better off as a result of this change alone. I hope it may be possible to extend this lower rate band in future years.
I still believe, however, that it is necessary to raise the tax threshold as far as possible above the main social security benefit levels and to take as many people as I can out of tax altogether. I therefore propose this year to raise the single person's allowance and the wife's earnings allowance by a further £40 to £985 and the married allowance by £80 to £1,535.
This increase in tax thresholds will help widows and also provide the family man with special help during the second stage of the transition to the child benefit scheme. The additional child benefit which mothers are now receiving will, in general, more than offset the effect on family income of the reduction in the child tax allowance which we have already announced.
But I believe it is important too to ensure that this change does not reduce the father's pay packet, and for this reason I am increasing the married allowance by twice as much as the increase in the single allowance.
I propose, as last year, to ensure that the allowance for one-parent families is kept in line with that for two-parent families by increasing the additional allowance by £40 to £550.
Pensioners with a modest additional income have a special problem which I think all MP's have come across in their constituencies. I therefore propose to increase the age allowance a little more than personal allowances generally — by £50 for the single person and £100 for the married — and to raise the age allowance income limit to £4,000.
The cost of these measures will be £2.150m., of which nearly £1,600m. is attributable to the lower band and just over £550m. to the increases in the personal allowances.
As a result of these increases, 300,000 people who would otherwise have been paying income tax in the coming year will not now do so.
Although last October I increased the thresholds for the PAYE on the first pay day after May 10. Single people and earning wives earning over £19 a week will in general then get a refund of £1.30 and they will thereafter pay 26p a week less in tax. The refund for married men earning over £30 a week will in general be £2.60 and the weekly reduction for them will be 52p.
The new tax tables giving effect to the changes in rates of tax will operate from mid-July. There will then be a further refund of about £18 and a further reduction in tax of £1.30 a week.

### Effect on living standards

With the usual Budget tables, I am arranging to have published this year, as in the past two years, tables which show the effect of my tax changes on individuals at different levels of earnings.
In order to illustrate this, let me take first the example of a man earning £75 a week who has a wife and two children under 11. The tax reliefs in to-day's Budget will give him an extra £1.82 in his pay packet.
As I have said, however, these tax reliefs are only the second phase of the process which I began last October when he got an extra £1.05 a week.
From the beginning of this April the new provisions for child benefit and child tax allowances have come into force, as well as the increased national insurance contributions.
Taking all these into account, the £75 a week family is better off by £3.32 and, when the child benefit rises in November by a further 70p for each child, the family

will be better off by a total of £4.72 a week.
But these calculations do not take into account the effects of wage increases over the current pay round. Taking again the man on £75 a week, if his earnings rise by 10 percent in accordance with the Government's guideline, his standard of living will rise by nearly 6 percent in real terms between August, 1977, and August, 1978, as a result of last October's measures and of those I have just described.
The man earning £50 a week will do even better: his living standard will rise by nearly 7½ percent. On the same basis a single man on £75 a week will be about 4 3/4 percent better off, and on £50 a week will be just over 6 percent better off.

Thus I do not in this Budget make any call for sacrifice. With the rate of inflation remaining low, and with these substantial tax reliefs, modest increases in earnings should ensure that real living standards can continue to rise over the year ahead without unduly increasing our industrial costs.

This is the best possible recipe for commercial and industrial success. It is the only recipe for curing unemployment.

# Highlights from the financial statement*

### Income tax

It is proposed to increase the single person's allowance and the maximum wife's earned income relief from £945 to £985 and the married allowance from £1,455 to £1,535.
It is proposed to increase the additional personal allowance from £510 to £550.
It is proposed to increase the age allowance for the single person from £1,250 to £1,300, for the married from £1,975 to £2,075, and the age allowance income limit from £3,500 to £4,000.
It is proposed to introduce a lower rate of 25 percent on the first £750 of taxable income (with a separate lower rate band of £750 for a wife's earnings). It is also proposed to extend the basic rate band by £250 to £6,250 (reduced, as appropriate, by any wife's earnings charged at the lower rate).
It is proposed that the width of the 55 percent and 60 percent bands should be £1,500, that the width of the 70 percent band should be £2,500 and that the width of the 75 percent band should be £5,500. As a consequence of these changes, the structure of personal tax rates in operation in 1978-79 will be:

BANDS OF TAXABLE INCOME

| £ | Percent |
|---|---|
| 0 — 750 | 25 |
| 750 — 7,000 | 34 |
| 7,000 — 8,000 | 40 |
| 8,000 — 9,000 | 45 |
| 9,000 — 10,000 | 50 |
| 10,000 — 11,500 | 55 |
| 11,500 — 13,000 | 60 |
| 13,000 — 15,000 | 65 |
| 15,000 — 17,500 | 70 |
| 17,500 — 23,000 | 75 |
| Over 23,000 | 83 |

It is proposed to raise the threshold for the investment income surcharge for 1978-79 from £1,500 to £1,700, and to increase the 10 percent band to £550 so that the 15 percent rate is reached at £2,250. For persons aged 65 or over, it is proposed to raise the threshold from £2,000 to £2,500 with a 10 percent band of £500, so that the 15 percent rate is reached at £3,000. The resulting structure of investment income surcharge for 1978-79 will be:

BANDS OF INVESTMENT INCOME

| Under 65 | |
|---|---|
| £ | Percent |
| 1,700 — 2,250 | 10 |
| Over 2,250 | 15 |
| **65 or over** | |
| £ | Percent |
| 2,500 — 3,000 | 10 |
| Over 3,000 | 15 |

It is also proposed that maintenance payments should be exempt from surcharge.
As the second stage of the scheme to phase out child tax allowances and replace them with child benefit, it is proposed to reduce the child allowances to £100 for each child not over 11, £135 for each child over 11 but not over 16 and £165 for each child over 16 (as compared with their 1977-78 levels of £196, £231 and £261 respectively for first children, and £170, £205 and £235 respectively for subsequent children).
It is proposed that child tax allowances for certain children living abroad should be maintained at the level set for them in the 1977 Finance Act. It is also proposed to increase to £80 the exemption limit for child dependency allowance received by widows and certain other social security beneficiaries.
It is proposed that the income limit on a child's earned income for the purposes of the child tax allowance should be increased from £350 to £500.
It is proposed to introduce provisions to give some relief for the self-employed and members of United Kingdom partnerships living in this country and working abroad.
It is proposed to allow relief against general income of the three previous years for a trading loss sustained in 1978-79 or later, in the first year in which an individual carries on a trade or in any of the next three years.

It is proposed to introduce a provision to allow a farmer to average the profits of two consecutive years where there is a change of 30 percent in profits from one year to the other.
It is proposed to introduce provisions for taxing certain persons engaged in diving operations under Schedule D instead of Schedule E.
It is proposed to provide relief for profit sharing with effect from the year 1979-80.
It is proposed to increase the earnings limit above which the special rules for taxing benefits in kind apply from £7,500 to £8,500 with effect from the year 1979-80.

### Income tax and corporation tax

It is proposed to introduce an initial allowance of 20 percent for capital expenditure on agricultural buildings and works.
It is proposed to introduce capital allowances for expenditure on hotel buildings at the rate of 4 percent per annum with an initial allowance of 20 percent.
It is proposed to introduce provisions under which, following the grant of a lease of more than 50 years of an industrial building, the lessee may become entitled to industrial buildings allowances instead of the lessor.
It is proposed to make provisions with retrospective effect against the avoidance of tax by partnerships (other than partnerships between individuals) dealing in commodity futures.
It is proposed to make provision with effect from December 3, 1976, against the avoidance of tax by the sale of land with a right to repurchase.

### Corporation tax

It is proposed for the financial year 1977 to increase the lower and upper limits for the "small companies" rate of corporation tax from £40,000 and £65,000 to £50,000 and £85,000 respectively.
It is proposed to give further relief from apportionment to close trading companies for accounting periods ending after Budget Day.
It is proposed to reduce to 10 percent the rate of corporation tax on the chargeable gains of an authorised unit trust or approved investment trust as from April 1, 1977.

### Corporation tax and capital gains tax

It is proposed to provide relief for guarantee payments or losses incurred in respect of certain loans made to traders.

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## Capital gains tax

It is proposed to replace the small disposals exemption and the alternative basis of charge by an exemption for individuals of the first £1,000 of net annual gains, with a lower rate of 15 percent on the excess for gains up to £5,000 and a marginal relief for gains between £5,000 and £9,500.
It is proposed to provide a rollover relief for gifts, including partial gifts, of business assets and to make some improvements in the relief available for the replacement of business assets.
It is proposed to increase the maximum figure of gains eligible for exemption under the retirement relief provisions from £20,000 to £50,000.

## Capital transfer tax

It is proposed to amend the law relating to deeds of family arrangements and disclaimers.
It is proposed to extend the provisions relating to settled property.
It is proposed to extend the relief available for transfers to employee trusts.
It is proposed to prevent the avoidance of tax when certain insurance policies are taken out for the benefit of another person.

## Customs & excise

*Surcharges and rebates in respect of revenue duties*
It is proposed to extend for a further year the existing powers under Section 9 of the Finance Act 1961 which enable the Treasury by Order to impose a surcharge or allow a rebate in respect of the main revenue duties of customs and excise.

*Value added tax*
It is proposed to amend Section 20(1) and Schedule 1 to the Finance Act of 1972 relating to value added tax, so as to increase the registration limit to £10,000 per annum from April 12, 1978 and the deregistration limit to £8,500 per annum from July 1, 1978.
It is proposed to amend the law to enable the Commissioners of Customs and Excise to deregister a person who has ceased to be liable to be registered by virtue of paragraph 2 of Schedule 1 to the Finance Act, 1972, and who has failed to comply with the legal provisions relating to submission of returns or payment of value added tax.
It is proposed to introduce certain reliefs from the liability to value added tax in respect of bad debts where the debtor becomes formally insolvent.

*Tobacco*
It is proposed that from September 4, 1978, the specific rate of the excise duty on cigarettes shall be increased by £2.25 per 1,000 cigarettes in respect of cigarettes with a tar yield of 20 mg or more.

*Gaming licence duty*
It is proposed to amend the Betting and Gaming Act 1972 to provide that the gaming licence duty chargeable in Scotland for a period beginning after 31 March 1978 shall be based on the rateable value in force on that date.

### FORECAST EFFECTS ON NEW RATES

| INLAND REVENUE | Forecast for 1978-79 | Forecast for a full year |
|---|---|---|
| ***Income-tax*** | | |
| Increase in single allowance by £40 and married allowance by £80 ... | – 415 | – 500 |
| Increase in additional personal allowances by £40 | – 4 | – 5 |
| Increase in age allowances by £50 (single) and £100 (married), and in income limit | – 53 | – 67 |
| Introduction of lower rate on first £750 | – 1,317 | – 1,569 |
| Extension of basic rate band by £250 to £6,250 | – 52 | – 66 |
| Changes in higher rate bands | – 64 | – 140 |
| Increase in investment income surcharge thresholds | – 3 | – 31 |
| Exemption of maintenance payments from surcharge | Negligible | – 1 |
| Increase in child's earned income limit | Negligible | – 5 |
| Change in treatment of overseas profits of self-employed | Negligible | – 10 |
| Loss relief against general income for new traders | Negligible | – 5 |
| Averaging relief for farmers | Negligible | – 10* |
| Change to Schedule D assessment for certain divers | – 9 | – 1 |
| ***Income tax and corporation tax*** | | |
| Initial allowance for capital expenditure on agricultural buildings | Negligible | – 20† |
| Allowances for capital expenditure on hotel buildings | Negligible | – 15† |
| Industrial buildings allowances: long leases | Negligible | – 2 |
| ***Corporation tax*** | | |
| Increase in limits for small company relief | – 11 | – 20 |
| Further relief from apportionment | Negligible | – 2 |
| Decrease in rate on chargeable gains of certain trusts | – 7 | – 11 |
| ***Corporation tax and capital gains tax*** | | |
| Relief for losses on loans | Negligible | – 5 |
| ***Capital gains tax*** | | |
| Exemption and lower rate band | – 15 | – 65‡ |
| Rollover relief for lifetime gifts of business assets | – | – 5 |
| Increase of exemption under retirement relief provisions | – | – 5 |
| TOTAL INLAND REVENUE | – 1,950 | – 2,560 |
| CUSTOMS AND EXCISE | | |
| ***Value added tax*** | | |
| Increase in registration limits | – 5 | – 15 |
| Bad debts relief | – 15 | – 35 |
| ***Excise duties*** | | |
| Increase in duty on higher tar cigarettes | + 10 | + 25 |
| TOTAL CUSTOMS AND EXCISE | – 10 | – 25 |
| ***Total*** | – 1,960 | – 2,585 |
| | Forecast for 1979-80 | Forecast for a full year |
| ***Inland Revenue: Changes to take effect in 1979-80*** | | |
| Relief for profit sharing § | – 25 | – 100 |
| Increase in threshold for benefits in kind | – 3 | – 4 |

*The cost in 1979-80 will be £3m. † The cost in 1979-80 will be £5m. for agricultural buildings and £5m. for hotels. ‡ The cost in 1979-80 will be £40m. § The tax loss will depend on the extent of participation in profit sharing schemes, but might eventually exceed £100m.; the estimate of the cost in 1979-80 is speculative.

*Anti-dumping duties*
It is proposed to make amendments to the law relating to anti-dumping measures, to enable the United Kingdom to impose duties of customs on third country goods to give effect to obligations arising from its membership of the European Coal and Steel Community.

# CANADIAN BUDGET 1978

## THE TAX STRUCTURE

Our tax system is another instrument which can support innovation and change. I want to proceed immediately with major structural changes in three areas of industrial policy highlighted by First Ministers. They are research and development, transportation and energy.

### Research and development

We must continue to encourage Canada's research and development efforts. An adequate level of R&D is crucial to achieve gains in productivity and to strengthen Canada's position in an increasingly competitive world. At present, corporations are allowed to write off immediately 100 percent of all R&D capital and operating expenditures. Last year these outlays also became eligible for the federal investment tax credit of from 5 to 10 percent. In many cases they also qualify for direct assistance under significant federal grant programs.

I now propose that for 10 years starting this year, taxpayers be allowed to deduct from their income a further 50 percent of additional R&D expenditures. The deduction will apply to both current and capital expenditures to the extent that they exceed the average amount over the preceding three years. This means that there will now be a special incentive for companies to *expand* their R&D. I want to emphasize that this special allowance comes on top of the incentives already in place.

The new allowance will make Canada's tax treatment of research and development one of the most generous in the world. The after-tax cost to companies of one dollar's worth of additional expenditure will be reduced to as little as 20 cents. I hope this incentive will lead to significant improvements in R&D performance by the private sector. And I look to companies to ensure that the resulting new technology is used within Canada to create new jobs.

### Railway investments

Discussions at the First Ministers' conference underlined the importance of transportation for industrial and regional development in Canada. Railways continue to be a crucially important mode of transportation, particularly for long hauls and heavy commodities. Recently, the government has announced significant changes in the organization of the CNR to improve the efficiency of its operations. Measures were introduced in the last budget to encourage track and grading investments by railways. Looking to the medium term, major new investments are needed in this sector if efficiency and productivity gains are to be captured.

I am therefore proposing a significant increase in the capital cost allowance for railway investments. This will take the form of an additional depreciation allowance of 6 percent per year for five years for most capital expenditures of a railway. It will apply to investments undertaken after tonight and before 1983. The measure will help improve the railway system in all regions of Canada and will be of benefit to suppliers of railway equipment.

### Energy development incentives

We must also continue to place high priority on our national energy policy, and in particular the need to extend self-reliance for oil and gas. We are fortunate in our existing and potential resources, and many tax incentives and other measures have been put in place to encourage their development. But increasing attention is now focussed upon the heavy oil reserves and oil sands deposits of the western provinces which can be tapped only by advanced technology and multi-billion dollar investments. These are projects requiring long lead times for planning, organization, design and construction. It is important to get them moving now, and I have concluded that some modification and clarification of their tax treatment can be helpful in that regard.

First, I want to make clear that the upgrading plants to process the heavy oil produced from wells into a type of oil similar to conventional crude will be treated as a manufacturing facility, eligible for fast write-offs and the reduced tax rate.

Second, it will be important to extract as much oil as technologically possible from all deposits. It has already been established that enhanced recovery systems can greatly increase total production. After today, therefore, special machinery, equipment and other facilities acquired for enhanced recovery systems — specifically, so-called "tertiary" recovery — will be able to earn depletion at a rate of $1 for every $2 of expenditure as compared to the normal earning rate of $1 for $3.

Finally, enared depletion may be applied at present only to reduce taxable resource profits, and only up to a ceiling of 25 percent. This provision will be significantly improved. Effective immediately, corporations may deduct depletion earned through certain qualifying investment in non-conventional oil projects up to the extent of 50 percent of total income — both resource and other profits. The qualifying investment will include expenditures on tertiary recovery equipment and certain depreciable property acquired for use in a bituminous sands mining project.

I am confident that these measures, added to the ones already in place, will in future years help reduce our dependence on imported oil, especially in eastern Canada.

I would like also to say a word about the mining industry. The first Ministers' conference directed Finance and Resource Ministers to undertake an early review of the taxation of the mineral industry. The government is proceeding with its review and looks forward to further consultation with the provinces in the near future.

### Retirement income

Almost two million Canadians have Registered Retirement Savings Plans, enabling them to set aside funds to provide income after retirement. The wide range of choice allowed in setting up these plans and the generous tax treatment for contributions have made them very popular.

I have some concern, however, over the limited choice available to RRSP holders when the time comes to turn their savings into retirement income. A taxpayer is now required to invest his RRSP proceeds in a life annuity with an insurance company prior to his 71st birthday. The only alternative he has is to withdraw the funds in a lump sum and pay income tax on this amount in the same year.

I propose to introduce two additional alternatives that will increase flexibility while retaining the basic principle that RRSP funds are intended to be used for retirement income.

The first alternative will allow the purchase of a fixed-term annuity to provide benefits to age 90.

The second alternative will allow the taxpayer to have his RRSP savings placed in a new kind of investment vehicle to be known as a Registered Retirement Income Fund. Each year a set fraction of the total assets in the Fund — capital plus accumulated investment earnings — will be withdrawn and taken into income. This fraction will be determined by a formula designed to provide benefits to age 90. Payments would grow over time at a rate reflecting the investment performance of the Fund and thus provide a degree of protection against future inflation. There will be provisions enabling a taxpayer to manage his investments in much the same way as he can now with a self-administered RRSP.

Institutions with the right to issue RRSPs will be permitted to sell fixed-term annuities or retirement income funds. At present this includes mainly life insurance and trust companies.

The transfer of an RRSP into any of the retirement income options must occur between age 60 and age 71.

I am confident that the added alternatives will provide the range of choice that taxpayers desire in planning for retirement. They respond to concerns expressed to me by many Canadians.

### Family law reform

A number of provinces have introduced fundamental changes in the law relating to the division of certain properties between marriage partners. These changes in law raise a number of important issues which are far from being resolved. Because they affect several provisions of the Income Tax Act, I am monitoring the developments in this area very closely. In the meantime, I am proposing a change in the provisions so that transfers of property between spouses pursuant to provincial family laws will not give rise to taxable capital gains.

The Ways and Means Motion contains several other important changes. First, the current provisions which permit the transfer of farm land and buildings by a farmer to his children without payment of capital gains tax will be extended to incorporated family farms. Second, single employees will now receive the same tax exemption as married employees on the value of free board and lodging provided at logging camps and other remote work locations. Third, I am proposing certain tax changes to further promote the production of good Canadian films.

## PROBLEMS OF THE PAST YEAR

In addition to measures which will encourage structural changes in the economy, I have also had to consider what measures will be helpful in dealing with the immediate problems that confront us.

Although the prices of the things we produce continued to slow down last year, the prices of the things we consume have risen more sharply. There were two major factors — higher prices of imported foods and the decline in the exchange rate. I do not believe the price surge will last. I believe the direct impact of our dollar's decline is now largely behind us. Further, an improving supply situation should help to slow the rise in food prices.

The growth of output was disappointing last year. The rate dropped from about 5 percent in 1976 to 2.6 percent in 1977, according to the preliminary estimate. The most unfortunate consequence was the rise in unemployment. Unemployment has reached unacceptable levels despite a substantial increase in the number of Canadians who are working. Employment has increased more than 3 percent in the past year. Almost 300,000 more Canadians are working today than one year ago. But our labour force has also been growing rapidly, much more rapidly than in other countries. Since 1970, our labour force has increased by about 3½percent a year, compared with 2 percent in the United States and well under 1 percent in the United Kingdom, France and Japan. In Germany, the labour force has actually dropped over this period.

An important reason for the growth of our labour force has been the growing number of Canadian women who are working. Since 1970 the number of adult women in the labour force has increased from 1.9 million to 2.7 million, a rise of more than 40 percent. There has also been a surge of young people coming into the labour market. This surge will not last; in many schools, there are now empty desks. But the immediate challenge is to create enough jobs for all our young people. Youth unemployment is one of our most serious problems. It cannot be dealt with only by general economic policies. Our manpower training and direct job creation programs are pointed specifically to this problem.

In 1978-79 a total of $458 million will be spent for the Canada Works, Young Canada Works and other continuing job creation programs. Some of these programs, notably Young Canada Works, Summer Job Corps, Youth Apprenticeship and Job Experience Training are directed exclusively to young people. However, this does not represent our total effort in favour of young people. I must stress that the young also have complete access to our general programs such as Canada Works and the Canada Manpower Training Program where they represent roughly half of the clientele. I estimate our job creation effort for young people under these programs to be over $225 million.

Further, an additional $150 million is being provided for seasonal works projects with a high employment content in high unemployment areas. The new employment credit will directly stimulate private sector employment.

The stimulus will be especially strong for jobs which young people are most likely to fill. We are also making a manpower training investment of the order of $500 million, about half of which is to be spent on youth.

Mr. Speaker, if I may summarize, we are going through a difficult period of adjustment, with some recent factors working against the pace of our recovery. Forecasts for 1978, including my own, have been shaded down. But the recovery is proceeding. Employment is rising. Confidence is improving, although not as quickly as I would like to see. The question now is whether the gradual recovery that has been established should be given an added push from policy. I have decided that it should.

The size of such a push must take into account the forces of expansion that are already in place. Much of the tax action I took last winter has not yet worked through the system. Moreover, the decline in the exchange rate over the past year, by improving the competitiveness of our exports and domestic industry, will have an impact of major dimensions — provided we do not waste it through cost increases. Very large resource projects lie ahead of us. So while further action is desirable, it must be responsible action, and action aimed at the right target.

## THE ACTION WE NEED NOW

Any further stimulus should obviously be fast-acting. It should encourage consumer spending, not more spending by government. It should offset some of the temporary factors which are pushing up prices. This is particularly important now, on the eve of the start of decontrol.

A reduction of retail sales taxes fits these requirements best, and has the added advantage of benefitting all those who spend in Canada, even those who do not pay income tax. It will stimulate retail sales and therefore benefit, among others, the many small businessmen in this sector. The idea has been advocated widely by economists, business associations and others. Indeed, I made a proposal to the provinces last fall under which the federal government would compensate them for half of the cost of reducing retail sales taxes by two percentage points. Most provinces were unable to accept the proposal at that time in view of their fiscal positions, and I therefore proceeded with an income tax cut of up to $100 per person for this year.

Tonight I want to announce that I have made a broader proposal to my provincial colleagues.

I have offered to compensate them for a reduction of two percentage points in their retail sales taxes for a period of six months. In return, I have asked them to bear the cost of *either* a further one percentage point for the same period, *or* an extension of the two-point cut for a futher three-month period.

I recognize that the Atlantic Provinces are less able than the other provinces to bear this additional cost. I have therefore offered to compensate them for the full cost of three percentage points for six months.

To focus the tax cut on essential items, the reductions will not apply to amusements, tobacco products and alcoholic beverages for home consumption.

The federal compensation to the provinces will be made in the form of a temporary transfer of $800 million in personal income taxes, with small balancing payments in cash where necessary. Equalization payments will be insulated from the impact of the retail sales tax and the personal income tax changes.

Alberta does not have a sales tax and therefore will not benefit in the same way as the other provinces. However, the fiscal position of Alberta is very strong as a result of its oil and gas revenues and this has permitted significant further cuts in other provincial taxes. The Government of Alberta has raised no objection to our proceeding with the proposed arrangement.

Mr. Speaker, this measure can be an outstanding example of federal-provincial fiscal co-ordination and I want to express my deep appreciation of the co-operation I have received from provincial colleagues. If all provinces accept the federal offer, this will mean a tax cut to the economy of about $1.1 billion. About one-third would be paid for by the stronger provinces, about a third by federal deficit financing, and about a third by a cut in federal expenditures to which I will refer in a moment. The measure will boost real income by holding prices below the level which would otherwise be expected. The impact on the average price level should be about one percent for the period the cut is in effect. This cut provides a specific incentive to consumers to take advantage of temporarily lower prices. Its impact will be reflected in an early stimulus to retail and wholesale business, a call on output from the production line, and a lowering of tax cost on business.

## NEW ZEALAND: A GUIDE TO NON-RESIDENT WITHHOLDING TAX

[continued from p. 219]

*Accounting for deductions of withholding tax*

Payment of the withholding tax should be made by the 20th of the month following the month in which the tax was deducted. The payment should be accompanied by the form IR 67.
Full instructions for payment and certification are shown on the reverse of the form.

*Reconciliation of payments*

A progressive reconciliation of payments is made monthly. A non-resident tax deduction certificate IR 202 is to accompany each payment of withholding tax.

*Who deducts tax*

— Persons making payments of non-resident withholding income deduct the tax.
— Where a New Zealand agent receives a payment on behalf of a non-resident and the tax has either not been deducted or only partly deducted, the agent is required to deduct the withholding tax.
— If the tax has been deducted before payment to the New Zealand agent, a letter advising the agent of the amount deducted will avoid a double deduction of tax being made.

[continued on p. 233]

*How the income is taxed*

| CLASS OF INCOME | HOW TAXED |
|---|---|
| Dividends | — Subject to 15 percent tax on the gross payment<br>— The tax deducted is a final tax. |
| Royalties and Know-How Payments<br>— Royalties— or other like payments dependent upon production from or the use of any real or personal property | — Subject to 15 percent withholding tax on the gross payment except for United Kingdom residents where the rate is 10 percent of gross.<br>— Minimum tax that may be increased by annual assessment except in the case of Australia, Fiji, Malaysia, Singapore and United Kingdom where the withholding tax is final. |
| — Cultural Royalties— defined as a payment for the use, production or reproduction of, or the privilege of using, producing or reproducing a literary, dramatic, musical or artistic work in which copyright exists | — Subject to 10 percent tax on the gross payment for United Kingdom residents; and 15 percent tax for all others, except Canadian residents who are exempt.<br>— The tax deducted is a final tax. |
| — Know-How Payments— defined as all payments for the supply in connection with the carrying on of a business, of scientific, technical, industrial or commercial knowledge, information or assistance | — Subject to 10 percent tax on the gross payment for United Kingdom residents; and 15 percent for all others.<br>— Minimum tax that may be increased by the annual assessment except for Australia, Fiji, Malaysia, Singapore and United Kingdom where the withholding tax is final.<br>— Payments for reimbursement of expenditure are exempt from tax provided the prior approval of the Department is given. |
| Interest<br>— Interest paid to persons at arm's-length | — Subject to 15 percent tax (10 percent Australian and Fijian residents) on the gross payment.<br>— The tax deducted is a final tax. |
| — Interest paid to Associated Persons Associated persons are defined as—<br>— any two persons who are relatives<br>— any company and any person holding more than 25 percent of that company | — Subject to 15 percent tax on the gross payment.<br>— Minimum tax that may be increased by the annual assessment. |

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# UNITED STATES:

# Foreign Tax Credit

## French, Indian, Haitian and Cuban Taxes Reconsidered*

### I. In general

The Internal Revenue Service has been asked to reconsider a number of its published revenue rulings and acquiescences relating to the creditability of certain foreign taxes under section 901 of the Internal Revenue Code of 1954. Accordingly, the purpose of the instant Revenue Ruling is to review those prior published positions of the Service and to indicate what the position of the Service is with respect to those prior published revenue rulings and acquiescences.

Whether a foreign tax qualifies as an income tax within the meaning of section 901 of the Code depends on whether that tax constitutes an "income tax" as determined from an examination of the Federal income tax laws of the United States. *Biddle vs. Commissioner*, 302 U.S. 573 (1938), 1938-1 C.B. 309, and *Bank of America Nat'l T. & S. Ass'n v. United States*, 459 F. 2d 513, 515, 518 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 949 (1972). Thus, the courts have often said that a foreign tax will be considered to be an income tax within the meaning of section 901 only if that tax is the substantial equivalent of an income tax in the United States sense. *See, e.g., Commissioner v. American Metal Co.*, 221 F.2d 134 (2d Cir. 1955); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 123 (1970), *nonacq.* on another issue, 1971-2 C.B. 4.

To qualify as an income tax in the United States sense, a foreign tax must satisfy certain requirements. *See* Rev. Rul. 78-61, 1978-8 I.R.B. The first requirement relevant to this Revenue Ruling is that the gain on which the foreign tax is levied must be realized in the United States sense. The United States Federal income tax, a tax of general application, does tax in certain limited situations the constructive or deemed receipt of income.

However, as a whole, the Federal income tax is imposed on gain actually realized. *Eisner v. Macomber*, 252 U.S. 189 (1920), 3 C.B. 25. A substantially equivalent degree of realization is required with respect to foreign taxes. *Commissioner v. American Metal Co.*, 221 F.2d 134 (2d Cir. 1955); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 898 (3d Cir. 1943); and *Lanman & Kemp-Barclay & Co. of Colombia v. Commissioner*, 26 T.C. 582 (1956).

In addition to realization, the second requirement relevant to the instant case is that a foreign tax will not be considered to be an income tax in the United States sense unless its purpose is to reach net gain and it is so structured as to be almost certain of doing so. *Bank of America Nat'l T. & S. Ass'n. v. United States; Bank of America T. & S. Ass'n. v. Commissioner*, 61 T.C. 752 (1974). Generally, a foreign tax is almost certain to fall on net gain if levied on income computed in such a manner that it is very unlikely that taxpayers generally subjected to that tax will have to pay it when they have no net gain. *See* the United States Court of Claims decision in *Bank of America Nat'l T. & S. Ass'n. v. United States*, at 524, wherein it was stated that the "... only question is whether it is very unlikely or highly improbable that taxpayers subject to the impost would make no profit or would suffer a loss." See also, *Allstate Ins. Co. v. United States*, 419 F.2d 409 (Ct. Cl. 1969).

The final requirement relevant to the instant case is that in order for a foreign tax to qualify as an income tax in the United States sense, the tax in question must be imposed on the receipt of income by the taxpayer rather than on transactions such as sales or the exercise of a privilege or a franchise, such as exploiting natural resources. *Commissioner v. American Metal Co.; Keasbey & Mattison Co. v. Rothensies;* and Rev. Rul. 57-62, 1957-1 C.B. 241.

### II. French income tax on presumed income of non-domiciliary taxpayers

*Herbert Ide Keen v. Commissioner*, 15 B.T.A. 1243 (1929), *acq.*, VIII-2 C.B. 27 (1929), involved a French tax imposed solely on the French source income of individuals who maintain a residence in France but are not domiciled there (non-domiciliaries). These non-domiciliaries pay the aforementioned tax on estimated income fixed at a sum equal to seven times the presumed rental value of their respective residences in France, unless their actual French source income exceeds their estimated income. [1] If so, the tax will be computed on their actual income.

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* Revenue Ruling 78-62 published in Internal Revenue Bulletin, February 21, 1978 at 16.

1. *Editor's note:* This Statement is in so far incorrect that 164(2) of the French General Income Tax Code (CGI) imposed income tax on *five* times the estimated income and not seven times this amount. Note also that as of January 1, 1977 this provision was abolished. Currently non-domiciliaries may be subject to French income tax on *three* times the estimated income of their residence or residences situated in France (CGI, Art. 164C). However, persons of French nationality who are able to prove that they are in the country where they are domiciled subject to income tax on world-wide income, provided that this income tax is at least two thirds of the French income tax computed on the same taxable base, are exempt. This exemption also applies to non-French citizens whose country has concluded a tax treaty with France containing a non-discrimination provision, such as is the case under the French-United States tax

The tax paid by non-domiciliaries is separate from the tax paid by individuals who are domiciled in France. The latter pay a tax on their actual income from all sources and not some form of estimated income.

The United States Board of Tax Appeals held this French tax on estimated income to be a creditable income tax principally because it was an income tax under French standards. Relying on the decision in the *Keen* case, the Board reaffirmed the creditability of that French tax in *James R. Hatmaker v. Commissioner*, 15 B.T.A. 1044 (1929) (decided for the Commissioner on other grounds). However, subsequent to the *Keen* and *Hatmaker* decisions, the Supreme Court of the United States held in the *Biddle* case that in order for a foreign tax to qualify as a creditable income tax, it must satisfy the United States standard and not the foreign standard of an income tax.

It is apparent that the aforementioned French tax on estimated income does not satisfy any of the United States standards of an income tax discussed above. Such tax is imposed on estimated income fixed at seven times [2] the presumed rental value of a residence even if the non-domiciliary has not realized any gain from French sources or even if such gain as may have been realized is less than such estimated income. Thus, the Service is withdrawing its acquiescence in the *Keen* case and substituting a nonacquiescence therefor, see page 5 of this Bulletin. *Accord, Commissioner v. American Metal Co.*, wherein the court stated that *Keen* is in conflict with the later decision of *Biddle*. In addition, the Service will not follow the conclusion expressed in the *Hatmaker* case that the French tax is a creditable income tax.

## III. Indian income tax on purchases

Also decided prior to the *Biddle* case was *Burk Bros. v. Commissioner*, 20 B.T.A. 657 (1030) (decided for the Commissioner on other grounds). In that case the taxpayer, a domestic corporation that manufactured goat skins into leather, purchased some goat skins in India through its Indian office. As a result, India levied a tax on the income deemed to be derived by the taxpayer from the goat skins. This income was determined by multiplying the number of goat skins purchased by the difference between the average sales price of goat skins in Philadelphia and their average sales price in Calcutta. The resulting figure was reduced by certain transportation and skin preservation expenses. [3] The Board of Tax Appeals held the Indian tax to be creditable. However, because the tax in *Burk Bros.* was triggered by a purchase and was levied without reference to the amount of income, if any, actually realized by the taxpayer during the year, it does not satisfy the first and third requirements of an income tax discussed above. Accordingly, the Service will not follow the holding in the *Burk Bros.* decision that the Indian tax is a creditable income tax.

## IV. Haitian tax on rental value of buildings and land

Rev. Rul. 272, 1953-2 C.B. 56, involved a Haitian tax imposed at progressive rates under chapters III, IV, and V of the Haitian statute. Chapter III taxed the business income of associations, companies, corporations, except stock companies, individual or partnership enterprises, manufacturers, merchants and professional people. Income for purposes of chapter III was computed on a fixed-rate basis by multiplying by five the yearly rental value of the buildings and land occupied by the aforementioned taxpayers.

Chapter IV of the Haitian statute taxed the net profit of all partnership or individual enterprises, companies, and stock corporations conducting a business. For purposes of chapter IV, net profit was actual receipts less the ordinary and necessary expenses incurred in producing these receipts. Taxpayers who were subject both to the tax on net profits under chapter IV and the tax on income computed on a fixed-rate basis under chapter III were required to pay the net profits tax only on that portion of the net profit, if any, which exceeded the income computed on a fixed-rate basis under chapter III. Moreover, even if a taxpayer with this dual liability had no net profit, it still had to pay a tax on income computed on a fixed-rate basis.

Relying on the decision in the *Keen* case, Rev. Rul. 272 held that the tax imposed by chapter III on income computed on a fixed-rate basis qualified as a creditable income tax. The Revenue Ruling also concluded that the tax imposed by chapter IV was a creditable income tax. The tax imposed by chapter III is not triggered by a realization event in the United States sense and is levied on a base that is not computed from actual receipts. Therefore, the chapter III tax fails to qualify as a creditable income tax. Moreover, insofar as the chapter IV tax is concerned, the only creditable portion of such tax is that portion that exceeds the tax imposed under Chapter III. Accordingly, Rev. Rul. 272 is modified to eliminate the holding thereof that the tax imposed by chapter III of the Haitian tax is a creditable tax and to provide that a taxpayer may treat as a creditable income tax only that portion of the chapter IV tax that exceeds the taxpayer's tax under chapter III. However, the holding in Rev. Rul. 272 that the tax imposed by chapter V of the Haitian statute is creditable is reaffirmed because it is the substantial equivalent of an income tax in the United States sense.

## V. Cuban tax on unrealized net income of sugar mill owners

Rev. Rul. 59-192, 1959-1 C.B. 191, and Rev. Rul. 56-658, 1956-2 C.B. 501, dealt with certain Cuban Taxes on unrealized net income expected to be derived by sugar mill owners from processed sugar. The event that triggered the imposition of the taxes was the manufacture of the sugar and not its subsequent sale. Moreover, the net income of the sugar mill owners was computed by multiplying the amount of sugar produced in the mill by the average market price of sugar produced in the mills for the past three years and then reducing this figure by an arbitrary 60 percent figure to cover processing costs. Because the Cuban taxes in Rev. Rul. 59-192 and Rev. Rul. 58-658 were imposed independently of any realized gain, they do not satisfy the United States realization standard. Moreover, if a sugar mill subject to the Cuban taxes had a loss for any year by United States standards, it would still pay the tax because net income by Cuban standards is 40 percent of the average market price of sugar produced by the mill for the past three years. Therefore, the taxes fail to meet the second United States standard that the

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treaty of July 28, 1970 (as amended) (Art. 24). See for a discussion of the new French legislation: D.A. van Waardenburg, "France: Reform of the taxation of resident and non-resident individuals" in 16 European Taxation 400 (December 1976).

2. Id.
3. *Editor's note:* Indian income tax is normally levied on income accruing or arising in India. However, in some cases foreign-source income is *deemed* to have accrued or arisen in India, which will, for instance, be the case where a nonresident has a "business connection" in India (Indian Income Tax Act 1961, Sec. 9)1)). A branch office, even if only utilized for the purchase of goods, will always constitute such a business connection. Consequently, income derived through the sale of goods which have been purchased through an Indian branch office is subject to Indian income tax.

foreign tax must be almost certain of falling on net gain. For these reasons the Cuban taxes are not creditable income taxes. Accordingly, Rev. Rul. 59-192 and Rev. Rul. 56-658 are revoked.

In *Santa Eulalia Mining Co. v. Commissioner*, 2 T.C. 241 (1943), *acq.*, 1946-1 C.B. 4, the United States Tax Court held that a Mexican tax of 10 percent imposed by Articles 26(I) and 27, Chapter IV, Third Schedule, of the "Ley del Impuesto sobre la Renta" is a creditable income tax under a predecessor of section 901 of the Code. The "Ley del Impuesta sobre la Renta" (Law) imposed a series of schedular taxes on various classes of taxpayers. The First Schedule of the Law imposed a tax on taxpayers engaged in commerce, industry, and agriculture and thus would include taxpayers actively engaged in the conduct of a mining business in Mexico.

Article 26(I) of the Third Schedule of the Law imposed a modified gross income tax on "(t)axpayers who. . . receive participations, whether in the form of rentals or otherwise, from the exploitation of the subsoil or concessions granted by the Federal or state Governments or Municipalities." The amount of participations subject to tax are the gross amount received, less a limited number of deductions as set forth in regulations issued under Article 27. However, persons who are actively engaged in the mining business in Mexico, ". . . taxpayers whose income consists of a participation in the profits of the exploiting concern ...," are specifically excluded from Article 26(I) of the Third Schedule of the Law because they pay tax under the First Schedule of the Law. Thus, only taxpayers not engaged in the conduct of a mining business in Mexico who receive participations are subject to the tax imposed by Article 26(I).

Though the tax imposed by Article 26(I) falls on the gross amount of participations received by the above taxpayers as reduced by a limited number of deductions, the tax does not violate the third requirement of an income tax discussed above. Because the above taxpayers are not engaged in the conduct of a mining business in Mexico, it is presumed that the expenses ordinarily connected with such participations and incurred by such taxpayers will almost never exceed the income from such participations. Therefore, the foreign tax imposed on such participations as reduced by the aforementioned deductions will be almost certain of reaching net gain. *Bank of America Nat'l. T. & S. Ass'n. v. United States*, and Rev. Rul. 73-106, 1973-1 C.B. 343, holding a Mexican tax imposed on the gross amount of royalties received by nonresident aliens and foreign legal entities not established in Mexico to be a creditable income tax. Additionally, similar taxes have long been imposed by the United States on dividends, interest, and royalties paid to nonresident aliens and foreign corporations (that are not effectively connected with the conduct of a trade or business in the United States) as a basic part of the United States income tax system. *See* sections 871(a)(1)(A) and 881(a)(1) of the Code. The thrust of these United States tax provisions is realistically directed against net gain or profit. *See Bank of America Nat'l. T. & S. Ass'n. v. Commissioner*, 61 T.C. 752 (1974).

Accordingly, because the tax imposed by Article 26(I) and 27 of the Third Schedule of the Law is the substantial equivalent of an income tax in the United States sense, the Service reaffirms its acquiescence in the decision in *Santa Eulalia Mining Company*.

Pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will not be applied to taxable years beginning before January 16, 1978, with respect to taxpayers who have relied on Rev. Rul. 59-192, Rev. Rul. 56-658, and Rev. Rul. 272, but only insofar as the specific taxes discussed in those Revenue Rulings are concerned.

Rev. Rul. 272 is modified. Rev. Rul. 59-192 and Rev. Rul. 56-658 are revoked.

## NEW ZEALAND:
## A GUIDE TO NON-RESIDENT WITHHOLDING TAX

[continued from p. 229]

*How the income is taxed*

| CLASS OF INCOME | HOW TAXED |
|---|---|
| Interest paid to associated persons continued<br>— any two companies which consist substantially of the same shareholders or are under the control of the same persons<br>— a partnership and any person, where that person and any partner in that partnership are associated persons by reason of the criteria above. | |
| The Australia, Fiji, Malaysia and Singapore Double Taxation Agreements vary the general definition.<br>— Interest paid to a Person with a fixed establishment or business within New Zealand<br>A fixed establishment specifically includes:<br>a branch, workshop, shop, factory, agricultural property or place where natural resources are or can be exploited but does not include the use of facilities solely for the purpose of storing, displaying or delivering goods or a fixed place of business maintained solely for the purpose of purchasing goods, collecting information or advertising for business. | — Not subject to non-resident withholding tax.<br>— Assessed on an annual basis. |

*More information*

If you require more information please do not hesitate to write to—

Absentee Centre, Inland Revenue Department, Private Bag, DUNEDIN.

# Bibliography

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# Cumulative Index 1978 - Nos. 1, 2, 3 & 4

# Contents

of the June 1978 issue



**In next issues:**

The German corporation tax reform and the revision of double tax treaties
— by *Dr. Theodor Faist*

Compensation of expatriates transferred to Brazil
— by *Aleksas Juocys*

Recent developments in Australian Federal Fiscal Arrangements
— by *G. Thimmaiah*

Current status of studies and work on tax treaties; LAFTA and Andean Pact
— by *Ramón Valdés Costa*

The evolution of Mexico's public revenue structure, 1877-1977
— by *Arthur J. Mann*

Tax structure and fiscal policy
Bangladesh: by *K.A. Dewan*
India: by *M.C. Bhatt*
Sri Lanka: by *Chuntharampillai Sivaprakasam*
Pakistan: by *N.M. Qureshi*

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

# Legal Regulation of Taxes, Levies and Fees in the Czechoslovak Socialist Republic

by Dr. Milan Bakes*

## PART 1

### I. CONCEPT, FUNCTION AND CONSTRUCTION OF TAXES, LEVIES AND FEES

State revenue is part of the national income distribution and redistribution relations constituting the complex system of financial relations. Under socialism, State revenue serves to secure and fulfill all the functions of the socialist state. Its distribution to the various areas must be done in a manner consistent with the requirements of the planned development of the socialist society.

In Czechoslovakia the term "State revenue" includes the Federal Budget receipts, receipts of the Budgets of the Republics, receipts of the National Committees on all levels and finally receipts of the State Funds and National Committees' Funds. Some economists sometimes embody in this category even receipts of the State economic organisations. 1

The majority of the State revenue in socialist countries, and consequently in Czechoslovakia too, has the appearance of an irretrievable drawing off of a part of the income of corporate and natural persons — and eventually from State economic organisations — even of a part of the value of their basic funds. Such a drawing off cannot be compared, since the corporate and natural persons concerned do not get any direct countervalue for the payments made. The funds obtained are again distributed and mostly used to cover budgetary expenditure connected with the financing of economic, cultural and social needs, administration, courts of justice, security and armed forces, etc.

The most important means of drawing off part of the net income of corporate and natural persons are taxes, levies, contributions, fees and customs duties.

Both *levies* and *taxes* are compulsory irretrievable payments for the benefit of the State. Whereas taxes are paid by corporate and natural persons, levies are collected from the State economic organisations only.

Distinction between levies and taxes was based on the form of ownership and on its changes. Taxes, with the exception of the turnover tax, were characterised as payments by other than economic organisations and here came about, and in the majority of cases are even nowadays coming about, changes in the form of ownership — from personal, cooperative or private ownership into State ownership. But, dispite the mentioned exception, this does not fully apply since even some State economic organisations pay taxes these days.

The economic substance of levies was preserved and in their instance it will always be a matter of redistribution of means from one State socialist authority to another — the means passing from the State economic organisations to the State Budget or to the National Committees' budgets.

*Contributions* are as a rule payments with a predestined application. They are paid in the CSSR both by the State economic organisations and other corporate as well as natural persons. Social security contributions by organisations are primarily described as contributions. When paid by the State economic organisations they are of the same (economic) nature as levies.

## TABLE OF CONTENTS



* Head of Financial Law Department, Faculty of Law, Charles University, Prague.

1. See Picmaus and Coll.: Taxes, Levies and Fees in the CSSR, SNTL. Praha 1974. Page 12.

*Fees* are payments for which natural and corporate persons are liable in connection with the work of a competent body done at their instigation or in their interest. *Fees are sometimes even levied partially to compensate State authorities for work done by them or as a possible deterrent to prevent tax payers from over-burdening State authorities with work.* Suggested reasons for the introduction of some fees are property increase (some of the notarial fees) or material benefits from granted concessions (e.g. some administrative fees).

Such attributes of fees are, however, of a rather secondary nature. Fees, like taxes and levies, are above all an instrument of national income distribution to raise new funds to cover all social needs.

Close to fees in nature were *dues* which practically no longer appear in the Czechoslovak revenue system. The only exception is the substitute due for the turnover tax levied by reason of equalising domestic and foreign price levels, together with customs duty from natural persons in gratuitous imports of articles for their personal use or for that of close relatives.

A particular kind of revenue is *customs duties* which, as budgetary revenue, are of subsidiary importance. These are levied in connection with the transportation of articles across the State border from persons importing or exporting such articles or from persons for whom such articles are imported or exported.

Taxes, levies and fees fulfil a number of functions. The most important are indisputably the accumulating and regulating functions.

*The accumulating (fiscal) function* means that levies, taxes and fees constitute an essential part of the State budget and of the National Committees' budget revenue. With taxes, levies and fees a part of the income of organisations and citizens is drawn into the State funds, from which all social requirements are covered. So, for instance, in 1975 the share of the levies and taxes in the total revenue of the State budget and in that of the budgets of the National Committees was 83.42 percent, the major part of the revenue — about 72 percent — consisting of levies and taxes from organisations.

*The regulating function* is closely linked with the redistribution of the available funds ensuring better use of the incomes created by corresponding redistribution. The function allows levies and taxes paid by organisations, in particular the turnover tax, to take an important part in affecting the extent and structure of production and consumption. The substance of the taxes paid by the population consists in the regulation of the rate of taxation according to the nature of the income source.

In addition to these two functions, a number of other functions come into consideration. With the taxation of citizens' incomes it is *the social function* which allows determination and differentiation in accordance with the taxpayer's family and social needs, with some levies and taxes paid by organisations, in particular with the capital tax levy and land tax, *the standard setting function* ensuring most effective use of production means. The levy or tax liability is directly dependent on pre-established criteria. With the land tax, for instance, it

**GENERAL INFORMATION ON CZECHOSLOVAKIA**

*Area:* 127,877 square km.
*Population:* 14.98 million (1976); 117.2 square km.
*Capital:* Prague; population: 1.17 million (1976).
*Government form:* Federal Republic composed of two autonomous republics, the Czech and the Slovak Socialist Republic.
*Currency:* Koruna (1 US $ = 5.75 Koruna (Kcs)).
*Gross national product:* US $ 61.34 billion (1976).
*Per capital income:* 25,700 Kcs (1976).
*Total tax revenue* (socialized and private sector)*:* 247,173,000 Kcs (1974).

is the average yield which the taxpayer has to achieve. Should his results exceed the standards set or fall below them this would have a direct bearing on the taxpayer's interest in the outcome of the production either by higher or reduced profit.

A particular part is taken by *the controlling function* filled mainly by the taxes and levies paid by the socialist organisations, a typical example of which is the turnover tax, through which fulfilment of production and sales plans of enterprises is controlled.

The tax and levy liability and the condition of its genesis, duration and extinction are established by statute, fee liability either by statute or by rules of lower authorities. Tax acts and mostly also levy and fee regulations determine the prerequisites, i.e. the elements which establish the legal relations connected with the tax.

For such legal relations to come into existence (only taxes are further referred to, though it is with minor exceptions similar in the instance of levies and fees), the tax act must possess the following prerequisites:
— the subject of the tax;
— the object of the tax;
— the basis of assessment;
— the rate of tax.

In addition, the respective legal relations contain or may contain other elements, such as increases and reductions, exemptions, taxable minimum provisions, maturity provisions, etc.

*Subject to the tax* is the person liable under the regulation to pay tax. Such natural or corporate person is called *the taxpayer*. In a number of instances it is not the taxpayer who remits the tax, but the liability is imposed by statute on another person — *the tax remitter*. For instance, in the case of the wages tax the taxpayer is the person receiving wages for the work done, but the payer is the organisation employing the taxpayer. The tax remitter is also subject to taxation. Should the taxpayer be unable or unwilling to discharge his statutory liability, enforcement of such liability follows either on himself or on another subject, *the guarantor*, on whom such liability is imposed by statute.

The taxpayer and/or guarantor as well as the tax remitter are liable subjects. The entitled subject is the respective financial administration office authorised to collect the tax and charged with its administration.

*Object of the tax* is the economic fact, on the basis of which the taxpayer becomes liable to tax. This may be some income or yield from economic activities or property.

*Basis of assessment* is the taxation object expressed in money, on which the tax is assessed. While the object of the tax tells us the reason for the establishment of the liability to tax, the assessment basis defines how the tax is assessed. For instance, the object of house tax is buildings destined for continuous purposes, the tax assessment basis is, after the kind of ownership, either the built-up area or the rent and price of use.

*Rate of the tax* is the yardstick by which the basic tax is computed in relation to the assessment basis. In principle it may be either fixed or sliding.

*Fixed rate* is a rate set by a fixed amount regardless of the assessment basis. An example of the fixed rate is the rate of arbitration fees in pre-contractual suits, in contract amendment or cancellation suits, in suits the object of which it is impossible to evaluate (500 Kcs) and in suits for basic delivery terms (1200 Kcs). A special kind of fixed rate is the rate fixed by margin. For instance, in the case of the house tax with the basis established according to the built-up area, the rate in municipalities with less than 6,000 inhabitants is 0.80 to 1.20 Kcs per square metre.

*Sliding rate* expresses the ratio of the tax to the assessment basis and is as a rule established by a percentage. If on the different bases the same percentage is charged (e.g. on 1,000 Kcs, 10 percent; on 1,500 Kcs, 10 percent, etc.), it is called *linear rate*; if with the growing assessment basis the percentage of the rate goes up (e.g. on 1,000 Kcs, 10 percent; on 1,500 Kcs, 15 percent, etc.) it is called *progressive rate*; and in contrary cases, i.e. the higher the assessment basis the lower the percentage rate (e.g. on 100 Kcs, 10 percent; on 1,500 Kcs, 5 percent, etc.) it is called *degressive rate.*

In the Czech taxation system progressive rates are mostly used. These may be progressive sliding or progressive step-rates.

In *progressive step-rates*, which are very seldom applied (e.g. in notarial fees from immovable assets, from inheritance and from donations), there is on shift from one zone to another a relatively sharp increase; in *progressive sliding rates* (the great majority of taxes and fees), the shift is gradual.

*Example: progressive step-rate (notarial fees from the transfer of immovable assets):*

| Basis less than Kcs | Common rate (%) | Favoured rate (%) |
|---|---|---|
| 4,000 | 6 | 6 |
| 10,000 | 7 | 2 |
| 20,000 | 8 | 2.5 etc. |

*Example: progressive sliding rate (wages tax):*

| Monthly basis Kcs from | to | Tax payble |
|---|---|---|
| 300 | 400 | – 8% |
| 400 | 600 | 32 Kcs and 10% of the basis exceeding 400 Kcs |
| 600 | 800 | 52 Kcs and 11% of the basis exceeding 600 Kcs. etc. |

Of the other tax elements, most of which are clearly defined (e.g. tax increases or reductions, tax exemptions), the exemption limit and the minimum assessment basis should be mentioned. Exemption limit should be understood as that part of the assessment basis on which no tax is levied. In the instance of the wages tax the exemption limit is 200 Kcs per month, in the instance of the income tax on residents if the taxpayer is dependent on income subjected to that tax, 2,400 Kcs a year, etc.

From the exemption limit differs the *minimum assessment basis*, the basis on which a tax has to be minimally levied. So in the instance of the income tax on residents the generally established basis is the total sum of all net income for the period of a calendar year, computed as the difference between realised receipts and the expenditure connected with their acquisition. In respect of tradesmen the minimum assessment basis to be applied, should the generally established basis be lower and even should the taxpayer suffer a loss, is a sum equal to 30 percent of the employees' gross wages cost.

Among the important elements of legal regulations connected with tax are the *maturity* of taxes, levies and fees. Maturity is the moment at which the law connects the discharge of the payment liability by the taxpayer. From the formal legal viewpoint this time element in legal regulations is analogous to that existing in other monetary obligations, e.g. in civil law obligations. The specificity of the time limits for taxation purposes (and similar time limits) consists in that these liabilities to pay represent the share of the State in the national income produced yearly; therefore normal maturity is as a rule situated in the period of the year in which the national income drawn was produced.

## II. REGULATIONS OF LEVIES AND TAXES PAID BY ORGANISATIONS

### A. Turnover tax [2]

The turnover tax was introduced as of 1 January 1953 instead of the former purchase tax of 1948.

The significance and purpose of the turnover tax today consists above all in the fulfilment of the accumulating, controlling and regulating functions.

The turnover tax is *remitted* by:

a. Sales and supplies organisations;
b. Manufacturing enterprises selling goods without the intermediary of sales organisations;
c. Enterprises purchasing agricultural produce;
d. Some commercial establishments, being of the nature of a:
   — State economic organisation;
   — popular cooperative or uniform agricultural cooperative;
   — cooperative enterprise;
   — social organisation enterprise.

2. The turnover tax is levied on the basis of Law No. 73/1952 and a Regulatory Decree to that Law No. 95/1967, as amended by Decrees No. 171/1973 and No. 113/1974.

The turnover tax is collected from the organisation (*tax remitter*) supplying goods to the trade network or for final consumption. In principle, the turnover tax is not paid by budgetary organisations, foreign trade organisations in respect of articles destined for export or of imported articles, and by private manufacturers.

*The object of the turnover tax* is the turnover from the sales of the organisation's own manufacture or own purchase of goods, the turnover of such goods being taxed but once.

Goods of the organisation's own manufacture are understood to be articles obtained by the organisation by its own primary production, processing, refining or make-up, articles obtained by the organisation from its own materials on its premises or ordered by it to be made elsewhere from its own materials, residues from processing, or manufacturing use of its own materials, used or worn articles restored by the organisation, articles obtained by the organisation by dismantling units into their component parts, for instance by stripping machinery and other equipment and articles resulting from construction work. *Goods of the organisation's own purchase* are articles purchased from socialist organisations for prices without turnover tax, agricultural produce bought from farmers running their own farms, from growers, breeders, etc. as well as all articles purchased from private manufacturers, including purchases of previous metals and stones and jewels from citizens.

*The assessment basis for the turnover tax* or the taxable turnover is the selling price of the goods, the applicable principle being that the sales of the goods are realised at prices including the turnover tax.

Determination and computation methods of the turnover tax are closely linked with the formation of prices. For the computation of turnover tax three kinds of tax rates are set down:

a. *Differential* — the difference between the fixed retail or selling price (in respect of goods not sold in the market for which no retail price was established) and wholesale price less trade discount or its part;
b. *Percentage*;
c. *Fixed*.

The differential rate is applied mostly to articles classed in the fixed price category (mainly essential goods, such as potatoes, milk, meat, textiles, shoes, etc.) For the purpose of determining the rate, lists with fixed retail prices (RP) and wholesale prices (WP) are issued. Normally, the rates are determined according to the following formula: $\frac{RP - WP}{RP} : 100$.

The percentage rate is applied to articles in the limited and free price category and to some articles with fixed prixes. The fixed rate is applied rather exceptionally.

## B. Levies for the State Budget [3]

The system of the State budget levies consists of:
- profit levy;
- capital levy;
- social security contribution;
- fixed assets depreciation levy;
- supplementary levies;
- levy collected from State economic organisations whose relation to the State budget or to the National Committee budget is determined by the financial plan.

*Subject* to the State budget *levies* are:
- State economic organisations engaged in industrial or building activities;
- State economic organisations mostly engaged in commercial activities;
- State design, design engineering and engineering organisations;
- State economic organisations engaged in research and development;
- State selling and supplying organisations;
- State Spa economic organisations (exploiting mineral sources);
- State organisations in the field of public road transport;
- State economic organisations in the field of culture;
- boards of management, provided at least half of their subordinate organisations are subject to profit levy pursuant to the above quoted Act;
- other State economic organisations whose relation to the State budget is not determined by the financial plan;
- domestic joint stock companies;
- organisations created on the basis of an association agreement (pursuant to Section 360 of the Economic Code), provided at least half of their members are organisations subject to levies under the above quoted Act;
- State economic organisations in the field of civil aviation;
- economic organisations with foreign participation having their seat in the Czechoslovak Socialist Republic and branches of economic organisations with foreign participation established in the territory of the Czechoslovak Socialist Republic capable of acquiring rights and incurring liabilities in their own name.

Accordingly subject to levies for the State budget are the great majority of State economic organisations, foreign trade organisations and inland joint stock companies, except:
- organisations taxed under the Income Tax and Social Security Contribution Act; [4]
- taxpayers paying agricultural profit tax pursuant to the Agricultural Tax Act. [5]

### 1. *Profit levy*

This is the fundamental and most important levy in the whole levy system. Its purpose is accumulation and centralisation of funds and regulations of the income of enterprises.

3. These levies are based upon the Law on State Budget Levies and Social Security Contributions No. 111/1971, as amended by Law No. 154/1976 (concerning social security contributions) and Law No. 62/1977 (concerning the system of levies and taxes paid by organisations). As a regulatory ordinance to the above law, the Minister of Finance published Decree No. 112/1971, which was also amended by Law No. 62/1977.
4. See under II. C, infra.
5. See under II. E, infra.

The profit levy *assessment basis* is the adjusted balance sheet profit made from the entire business of the economic organisations, including the management of its entire property, including additions and less deductions allowed.

Additions are, for instance, contributions and subsidies included in the costs which the organisation is not liable to bear under the appropriate regulations, gratuitous donations, the difference by which fines and penalties paid exceed those received, accounted surcharges to the damages for draining untreated or insufficiently treated waste water, accounted fees for environment pollution, including surcharge, etc.

Allowed as deductions are, for instance, capital levy paid, land tax paid, the difference by which fines and penalties received exceed those paid out.

*The rate* of the profit levy is linear, amounting to 70 percent, but for some branches set down by the Act the rates are scaled from 50 to 85 percent for inland trade, selling and supplying organisations, for economic organisations carrying on research and development and for some other organisations the levy is scaled in relation to profitability measured as a ratio of the adjusted balance sheet profit to the total of adjusted costs.

**TAX TREATIES CONCLUDED BY CZECHOSLOVAKIA**
(an astrerix indicates that the treaty is not yet in force)

Czechoslovakia – France: June 1, 1973
Czechoslovakia – the Netherlands: March 14, 1974
Czechoslovakia – Finland: January 31, 1975
Czechoslovakia – Belgium: June 19, 1975
Czechoslovakia – Japan: October 11, 1977

2. *Capital levy*

This is intended to produce proper economic pressure on effective utilisation of production funds. It expresses essentially the minimum yield limit within an economic organisation. It is allowed as a deduction from the profit levy assessment basis.

The levy *assessment basis* is the entire capital of an organisation consisting of:

– *the value of* the fixed assets and investment fund, *the value of* the fixed assets and investment repairs in use, *the value of* the construction fund and of the small investment fund of the enterprise;
– *the value of* the organisation's turnover fund, including *the value of* all the other funds, except the cultural and social needs fund and the technical development fund; in respect of inland joint stock companies also the paid-in shares.

From the assessment basis, i.e. from the organisation's capital, is deducted the residual value of some fixed assets which do not serve directly the main business of the enterprise and in respect of which, with a view to their nature, particular privilege is pursued, such as the residual value of fixed assets serving mostly housing, health, rehabilitation, education, cultural, sporting recreation purposes, provision of meals for the organisation's own staff or exclusively water and environment pollution control, safety and health protection of workers, etc.

The capital levy *rate* is 3 percent of the average value of the organisation's capital in the levy year. The rate of 2 percent is applied to building industry organisations, organisations mostly engaged in the manufacture of building material, organisations engaged mostly in the manufacture of structures and parts designed for capital construction, with the exception of the research and development basis State economic organisations and the State spa economic organisations, the rate for them being 10 percent.

3. *Social security contribution*

This is a compulsory levy from economic organisations to the State budget. Its purpose is to contribute partly to cover the expenditure connected with the labour power, including the health insurance premiums.

The assessment basis is the same as that of the wages volume levy, consisting of the wages fund accounted for in the current year to be paid out. Not included in the basis are awards to the best workers and collectives paid by the organisation from funds received out of the State budget, such as the award granted on the occasion of the bestowal of the Five Year Plan Flag or of a flag and standard of equal level.

The contribution *rate* is 20 percent of the basis, with the exception of the research and development basis State economic organisations and the State spa economic organisations, the rate for them being 10 percent.

4. *Fixed assets depreciation levy*

This is not paid by every individual enterprise, but by the ministries and other central authorities for their departments to the State budget. The levy is set down in the State budget by an absolute sum for the various central authorities in instances when depreciations of all the organisations subordinate to the central authority exceed the fixed share in its planned investments which may be covered from depreciations, or allow a reduction in the extent of investment allocations provided from the State Budget.

Use of fixed assets depreciations, including the redistribution of depreciations and the constitution of centralised construction funds, is governed by the CSSR Government's Decree on the Financial Economy of State Economic Organisations and Some Other Socialist Organisations. [6] The amount of the depreciations used for financing investment, the share of investment credits and other rules in this field are put into concrete terms by the competent Government for the individual years.

5. *Supplementary levies*

These levies are as a rule in the nature of a sanction and may be imposed on State economic organisations subject to profit levy.

6. Decree No. 151/1975.

Such levies are in particular designed:

- to drain funds obtained by an organisation through infringement of price regulations or in connection with price changes;
- to drain part of the profit, if equipment for the protection of workers was not installed or properly operated or if it does not comply with health and safety regulations;
- for fund redistribution governed by the CSSR Government's Decree No. 151/1976 Coll.;[7]
- to drain profit on articles of deficient quality or technically outdated;
- levy for exceeding the wages fund limits covered from the remunerations fund;[8]
- to ensure fulfilment of the National Economy Development State Plan of the Czechoslovak Socialist Republic. This supplementary levy is set down by the Government in accordance with the actual conditions and requirements for the individual periods of the Five Year Plan.

Conditions and the method of supplementary levy payment are laid down by the CSSR Government's Ordinance No. 151/1975.[9]

6. *Financial plan based levies*

The CSSR Government is authorised to set down the range of organisations to whom the general levy regulation of the economic organisations in force is not applicable but who shall pay levies on the basis of the financial plan.

Pursuant to the CSSR Government's Decree No. 151/1975 Coll. on the Financial Economy of the State Economic and Some Other Socialist Organisations, the relation to the State Budget or to the National Committee's Budget on the basis of the financial plan is applied to State economic organisations with prevailing public interest business and thus mostly to non-profit organisations. Concerned are railway and water transport organisations (including industrial and building organisations), telecommunications, State forestry, water economy, State and army film, geodesy and cartography organisations, military and spa and recreational facilities, banking and insurance (with the exception of the Czechoslovak Commercial Bank), independent computer control centre economic organisations, municipal public transport, housing economy and heat and power plants, cosmetics institutes and exhibition businesses controlled by National Committees.

7. *Other levies collected from economic organisations*

Classed among other levies are, inter alia, levies for removal of farming land from agricultural production, which is governed by a special statute: the Farming Land Fund Protection Act.[10]

The purpose of the levies is to prevent occupation of farming land for other than agricultural use and to improve land fund management. It is paid into the Land Fertilisation State Fund by those on whose application farming land is removed from agricultural production.

## C. Taxes in the private sector

1. *Income tax*

With the changed regulation of the levies from economic organisations the income tax was also changed. The present income tax regulation is anchored in the Income Tax and Social Security Contribution Act.[11]

The Act regulates both income tax levied in the form of profit tax and social security contribution.

*Taxpayers* of the income tax are:

- cooperative organisations with the exception of Uniform Agricultural Cooperatives;
- local economic organisations controlled by National Committees with the exception of housing organisations and small workshops run by Local National Committees;
- regional transport centres;
- district (municipal) building enterprises;
- branch mangement boards, associations of organisations, provided at least half their subordinate or member organisations are subject to taxation under the above quoted Act;
- other economic socialist organisations and their economic enterprises exercising continuous economic activities, provided their relation to the State budget is not governed by Act No. 111/1971 Coll. as amended by subsequent statutes — the full text promulgated under No. 72/1977 Coll.;
- other than socialist organisations, if they are corporate persons;
- commercial and civil law companies, institutes and endowments, public law corporation enterprises, associations of persons and other subjects having their seat abroad with the exception of natural persons.

*Exempt* from income tax are:

- manufacturing and working cooperatives of badly disabled citizens, economic enterprises of the Invalid Association employing badly disabled citizens and economic enterprises of cooperative associations operating selective recreation for their own members;
- house building cooperatives, people's housing cooperatives and other cooperative building societies (with the exception of district house construction cooperatives) in respect of income from such activity;
- housing cooperative associations with the exception of income from their own continuous economic activities.

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7. See note 6, supra.
8. Decree No. 157/1975.
9. See note 6, supra.
10. Law No. 53/1966, as amended by Law No. 75/1976.
11. Law No. 113/1971, as amended by the Agricultural Tax Law (No. 103/1974), the 1976 Federal Budget Law (No. 142/1975), the Social Security Contribution Amendment Law (No. 154/1976) and the Law on the systems of levies and taxes paid by organisations (Law No. 62/1977). As a regulatory ordinance to the above law, the Minister of Finance published Decree No. 114/1971, which was also amended by Law No. 62/1977.

2. *Profit tax*

Its nature and content are essentially the same as the profit levy. *Basis of assessment* for the profit tax are the overall activities of taxpayers and the income resulting therefrom, as evidenced by the accumulated balance sheet profit from such activities adjusted by increments and deductions. In respect of other taxpayers the assessment basis is differently adjusted in accordance with the kind and nature of their activities.

The additions are similar to those of the profit levy and include, inter alia, contributions and subsidies included in the costs which the organisation is not liable to bear under the appropriate regulations, gratuitous donations and refunds of capital levy and land tax paid. Allowed as deductions are again payments made in justified interest of the taxpayer or society, if not included pursuant to the regulations in the costs or not made to the debit of the accumulated balance sheet profit shown. Thus, the following may, inter alia, be deducted: capital levy paid, land tax paid, the difference by which fines and penalties received exceed those paid out, payments made to cooperatives or enterprises working for disabled persons, etc.

Both stock and fixed assets are to be valued at their historic cost, be it either the purchase or the manufacturing costs.

Fixed assets which are subject to wear and tear may be depreciated at a certain percentage of the costs of acquisition. Depreciation rates range from 1 percent to 25 percent per year dependent on the duration of the useful life in the taxpayer's hands. The duration of the useful life and the annual depreciation rates are set down in a list issued by the Ministry of Finance.

There are no investment allowances provided for under Czechoslovak tax law. However, upon request, enterprises may obtain special credits at reduced interest rates from the Czech National Bank for the financing of their investments.

The profit tax *rate* is progressive, differentiated according to the various taxpayer groups. The percentage of the taxation charge is determined in relation to the profitability level achieved: for organisations with *mostly commercial activities*, as a ratio of the balance sheet profit plus increment allowed to the overall costs less the sum by which the balance sheet profit was increased; for organisations with *mostly non-commercial activities* (local economy, manufacturing cooperatives, distric building enterprises and others) as a ratio of the adjusted balance sheet profit to the sum total of the balance sheet profit and wages, including other personal expenditure.

In the case of organisations with mostly commercial activities, the following tax table applies:

| *Profitability* | *Tax rate* |
|---|---|
| Up to 5% | 10% |
| Between 5 and 15% | 10%+ 2 times A |
| Between 15 and 30% | 30%+ 1 times A |
| Between 30 and 50% | 45%+ 0.5 times A |
| In excess of 50% | 55% |

In the case of organisations with mostly non-commercial activities, the following tax table applies:

| *Profitability* | *Tax rate* |
|---|---|
| Up to 10% | 25% |
| Between 10 and 15% | 25%+ 3 times A |
| Between 15 and 20% | 40%+ 2 times A |
| Between 20 and 25% | 50%+ 1.5 times A |
| Between 25 and 30% | 57.5%+ 1 times A |
| Between 30 and 35% | 62.5%+ 0.8 times A |
| Between 35 and 40% | 66.5%+ 0.6 times A |
| Between 40 and 45% | 69.5%+ 0.5 times A |
| Between 45 and 50% | 72%+ 0.4 times A |
| Between 50 and 55% | 74%+ 0.2 times A |
| In excess of 55% | 75% |

In this respect, the factor A is equal to the difference between the lower percentage limit of the bracket and the actual profitability percentage.

For taxpayers *having their seat abroad* the profit tax rate is linear depending on the nature of their activities, from 20 to 60 percent of the individual receipts.

In the case of royalties and similar fees, e.g. for technical assistance, payments for copyright and performance rights and interest obtained by individuals or entities resident abroad, the tax is withheld at the source at the following rates:

| | |
|---|---|
| Royalties and similar fees | — 40% |
| Payments for copyright and performance rights | — 25% |
| Interest | — 20% |

Cooperatives and enterprises owned by invalids, as well as social organisations, listed organisations with mostly non-commercial activities (local economic enterprises and manufacturing cooperatives) on receipts for selected activities (services) and, further, taxpayers training apprentices (except the last year) are granted profit tax relief.

3. *Social security contribution*

The function and construction of the social security contribution are the same as in the instance of the social security contribution governed by Act No. 111/1971.[12]

The contribution *rate* is differentiated according to the nature of the organisation's activities and to the economic conditions. Contribution at the rate of 20 percent is paid by foreign trade cooperative organisations and by organisations with mostly non-commercial activities with the exception of the part constituting the selected activities (services), for which a contribution at the rate of 10 percent is levied on the basis computed. The other organisations pay contributions at the uniform rate of 10 percent.

## D. Agricultural tax (paid by organisations)

The present agricultural tax law is given expression in the CSSR Federal Assembly's Agricultural Tax Act.[13]

12. See note 3, supra.

13. Law No. 103/1974, as amended by the Social Security Contribution Amendment Law (Law No. 154/1976) and the Law on the system of levies and taxes paid by organisations (Law No. 62/1977). As a regulatory ordinance to the above law, the Minister of Finance published Decree No. 106/1974, which was also amended by Law No. 62/1977.

The Act regulates the following:

a. Agricultural tax divided into:
   aa. land tax (including the tax paid by citizens);
   bb. profit tax; [14]
   cc. tax on excess wages and remunerations;
   dd. tax on citizens' receipts from agricultural production. [15]

b. Social security contribution.

1. *Land tax*

*The taxpayer* is every land user, i.e. all organisations entered in the immovables register as users of the land which is the object of the tax.

For land used as private farming land by members the tax is paid by the Uniform Agricultural Cooperative, which may require members using such land to refund the tax paid.
The *object* of the tax is all land entered in the immovables register as farm land, regardless whether such land is cultivated or serves other purposes than for agricultural production.
Of the non-agricultural land subject to the tax, ponds and private gardens used by citizens are included.

*Exempt* from the tax is recultivated land for a period of 5 years beginning with the year following that in which it reverted to agricultural production, land grown with choice sorts of vine of at least 1/4 of a hectare continuous area for a period of 6 years, intensive fruit gardens of at least 1 hectare continuous area for 4 years, hop and berry plants of at least 1/2 hectare continuous area for 2 years beginning with the year after planting, land temporarily removed from agricultural production by decision of a competent National Committee, land administered and used by National Committees and their budgetary organisations.

*Assessment basis* is the overall area of all the land subject to the tax; not included in the total area is one plot of the same user destined for recreation purposes if its area, exclusive of any built-up area, does not exceed 400 square metres. If the area of such plot exceeds that limit, its entire area is included in the total area of all the land.

The tax *rates* per hectare of land range from 50 to 1,000 Kcs depending on climatic, soil and terrain factors.
The amount of the rates is set down by the rate schedule constituting a part of the Act.
The tax rate for farmed areas is 50 Kcs per hectare.
Tax *relief* or *exemption* may be granted by the authority administering the tax on the taxpayer's application in the instance of prevailing facts enumerated by the Act, for example, on land under water conservation development, flooded land temporarily out of agricultural production, etc.

Increments are, for instance, contributions and subsidies included in the costs to which the taxpayer is not liable under the law, donations, the difference by which fines and penalties paid exceed those received, surcharges to damages for discharging untreated or insufficiently treated waste water, etc.

Allowed as deductions are, for instance, land tax paid, additional tax for non-agricultural activities, membership shares paid to agro-chemical enterprises.
The profit tax assessment basis, including increments and deductions, is essentially the same as in the instance of the State budget levies and of the income tax.

The profit tax rate is (i) either linear, being 50 percent of the assessment basis or 50 percent of the liquidation surplus in the instance of agricultural supply and purchasing organisations, branch management boards, associations of State economic organisations and taxpayers in liquidation, or (ii) progressive, being 0.8 percent for every percent of profitability achieved but not more than 40 percent of the assessment basis in the instance of all other taxpayers.

The computed profit tax may be increased by 10 percent on receipts from non-agricultural activities. The increase shall be prescribed, though the assessment basis was not shown, except in the case of enterprises taxed at the linear 50 percent rate.

2. *Tax on excess wages and remunerations*

*Taxpayers* of the excess wages and remunerations tax are Uniform Agricultural Cooperatives, *the assessment basis* being the difference between the volume of wages and remunerations charged to the costs in the taxation period and the direct remuneration cost standard. It is computed as the multiple of the average registered number of employees and the direct amount of remuneration per employee established for the individual years by Decree of CSSR Government. The tax *rate* is 50 percent.

3. *Social security contribution*

The function of the social security contribution as well as its construction are similar to those in the case of State Budget levies and income tax.
Social security contribution taxpayers are State economic organisations engaged in agricultural production and agricultural services, State economic organisations operating military forests and farms, branch enterprises, branch management boards, provided at least half their subordinate or associated organisations are subject to the contribution. *Exempt* from the contribution are State farms, seed cultivating and nursery enterprises and farms, large fattening stations and State breeding enterprises, as well as Uniform Agricultural Cooperatives, joint agricultural enterprises, joint coöperative enterprises and soil improvement cooperatives.
Social security contribution *assessment basis* in the instance of agricultural supply and purchase organisations, State economic organisations operating military forests and farms, branch management boards and associations of organisations in the volume of all the wage funds booked in a current year for payment reduced by the remunerations paid out from the sum obtained by the organisation as reward accompanying the grant of the Five Year Plan Red Flag, or a flag or standard of an equal level.
For the other taxpayers it is that part of the mentioned basis which makes up the share of receipts from non-agricultural activities in the total receipts.

The contribution rate is 10 percent.

14. See under II. C. 2 supra.
15. See under III. C. 2, infra.

**(continued in next issue)**

32nd International Congress of IFA (Sydney)

# FISCAL POLICY AND TAX STRUCTURES IN THE PACIFIC AND INDIAN REGIONS

On September 20, 1978 during the IFA Congress to be held in Sydney a special seminar will be devoted to the tax structures of countries in the Pacific Region and neighbouring areas and the fiscal policy followed by their Governments. This Seminar which will be chaired by Mr. S. Ambalavaner from Sri Lanka (Ceylon) has been largely coordinated by himself and Professor J. van Hoorn Jr., Managing Director of the International Bureau of Fiscal Documentation.

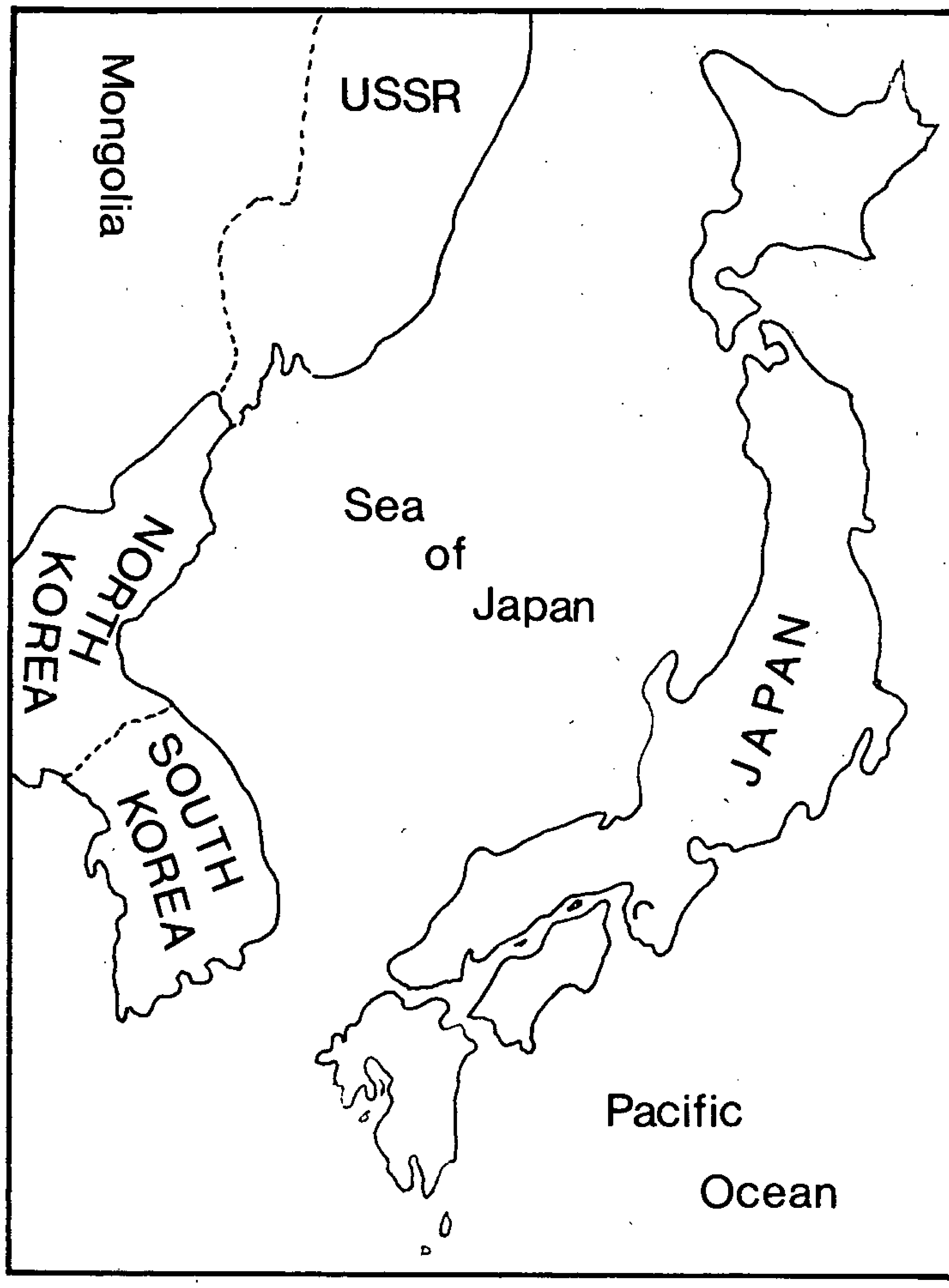
The Editors of the *Bulletin* are proud to be able to publish in this and forthcoming issues, papers dealing with the subject of fiscal policy in 12 countries situated in the Pacific and Indian regions.

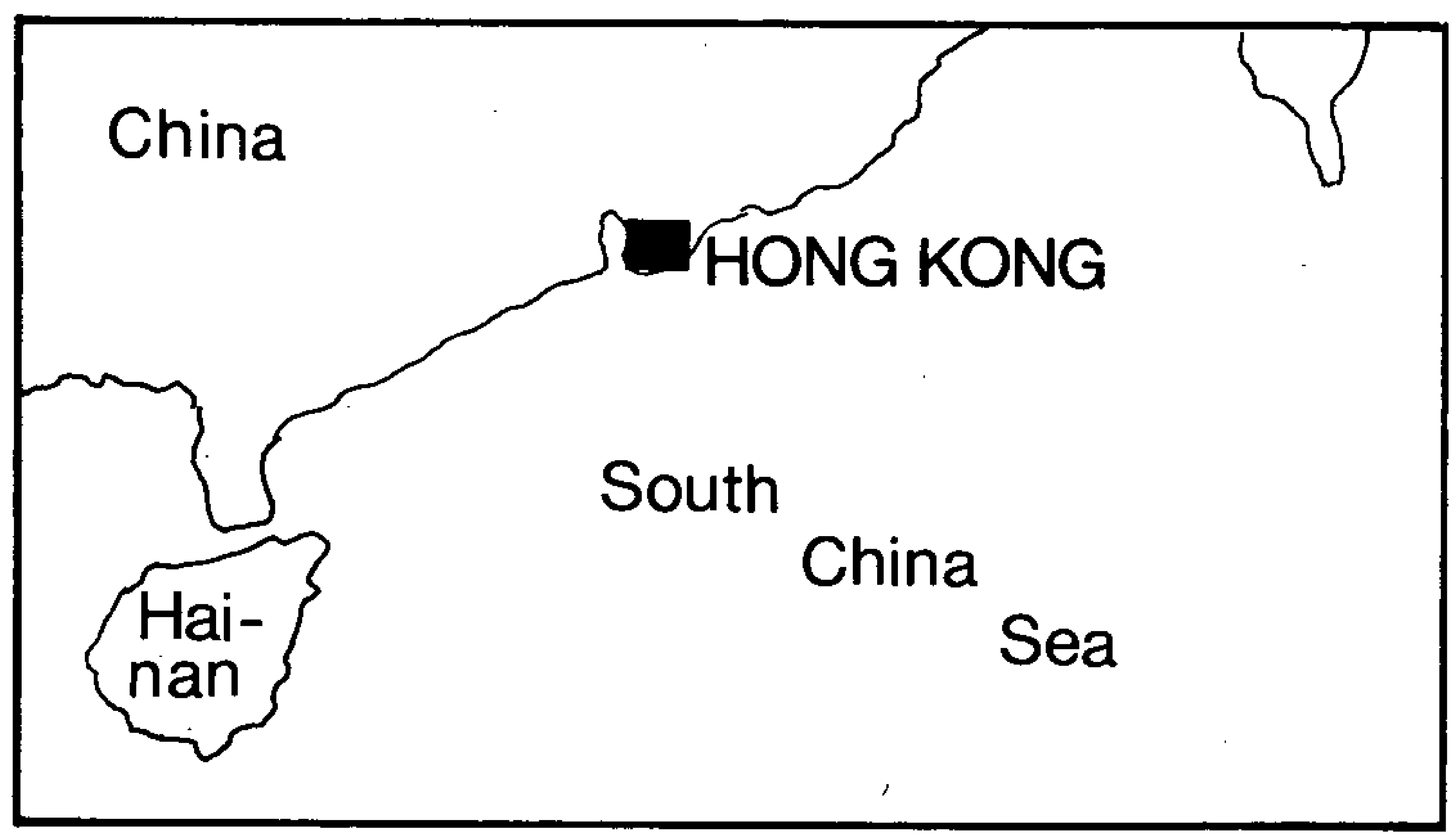
The first group of papers which appear in this issue comprise a number of Asian countries which are either highly developed, such as Hong Kong, Japan and Singapore, or which have reached a certain degree of development, such as South Korea.

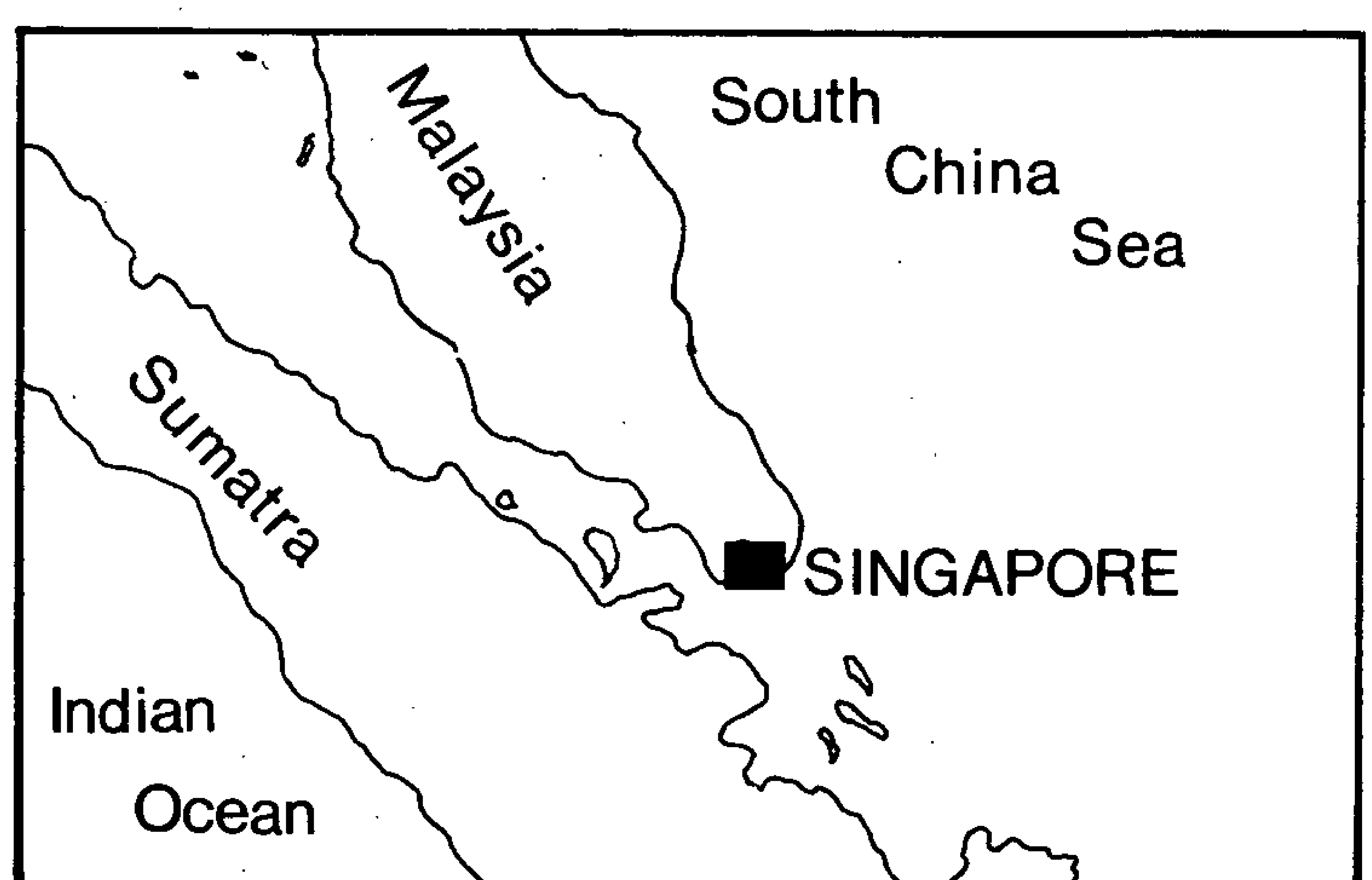
The second group of papers, to be published in the July issue of the *Bulletin*, will focus on developing countries in the Indian region and will discuss Bangladesh, India, Pakistan and Sri Lanka.

The third group of papers will — in honour of the 32nd Congress of IFA in Sydney — deal with Australia and countries in the neighbourhood of Australia, i.e. Indonesia, Philippines and Western Samoa.

A sufficient number of reprints of these papers will be available at the Sydney Congress for free distribution to the participants.



# HONG KONG:
# Tax Structure and Fiscal Policy

by Y.C. Jao*

## A. CATALOGUE OF TAXES AT THE NATIONAL LEVEL

### (a) Taxes on income

There is no global income tax in Hong Kong; instead, a "schedular" system applies, i.e. tax is levied on specified sources of income separately. Moreover, such taxes are levied on domestic source income rather than on world-wide income, i.e. only "income arising in or derived from" Hong Kong is chargeable to tax.

1. *Salaries tax* — this is a tax on all employment income, with provision for personal and child allowances. Marginal rates range from 5 to 30 percent, but subject to the maximum limit that total tax liability shall not exceed 15 percent of gross income before deduction of allowances. The tax is payable by both residents and non-residents.

2. *Business profit tax* — levied at a flat 15 percent rate on the net profits of unincorporated businesses.

3. *Corporation profits tax* — levied at a flat 17 percent rate on the net profits of incorporated businesses.

4. *Interest tax* — levied at a flat 15 percent rate on interest earnings from loans, bank deposits, annuities and other debt instruments, except government bonds. However, the Hong Kong Government has very recently accepted a recommendation by a tax reform committee[1] that bank interest from offshore loans and investments without the substantial intervention of an overseas branch should, as from April 1, 1978, also be brought within the tax ambit.

5. *Personal assessment* — an option open only to residents whereby incomes from various sources are aggregated and subjected to the same marginal rates, personal and child allowances, and the maximum limit as for Salaries Tax. Since this is a voluntary option, it is only chosen when the total tax liability thus assessed is actually lower than when earnings are separately taxed.

### (b) Taxes on property

1. *Property tax* — levied at a flat 15 percent rate on the assessed annual rental value of the property less a 20 percent allowance for repair and maintenance.

2. *Rates* — this is a tax in the British tradition on the occupier of premises for various municipal services such as water, lighting, police etc. and is levied at present at the rate of 11½ percent on the assessed annual rental value of the property.

3. *Estate duty* — levied on an inheritance at marginal rates ranging from 6 to 18 percent.

### (c) Taxes on goods and services

1. *Excise duty* — as Hong Kong is a free port, there is no general tariff, except for some specific duties on a few commodities of both domestic and foreign origin, namely, alcoholic liquors, tobacco, hydrocarbon oils, and a first registration tax on private cars.

2. *Betting duty* — charged at 25 percent on sweepstake contributions and lotteries, and 11 percent on other bets.

3. *Hotel accommodation tax* — levied at 4 percent on hotel bills paid by the guests.

4. *Entertainment tax* — charged on the price of admissions to cinemas at 8 percent.

5. *Stamp duty* — this used to be imposed on virtually all bills of exchange, promissory notes, contracts, commercial paper and documents, and conveyances. But in the latest 1978-79 Budget, a large part of the Stamp Duty has either been abolished or reduced. As from March 6, 1978, Stamp Duty applies only to contract notes on shares and marketable securities, assignments of immovable property, leases and assignments of leases.

6. *Other taxes* — lump-sum royalties are collected from public transport companies, TV stations etc. operated by private enterprises under franchise.

For tax revenue expressed as percentages of total revenue and Gross Domestic Product (GDP), see Appendix A.

## B. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, ESTATES AND GIFTS

### (1) Investment

The government, while welcoming both domestic and foreign investment in order to widen Hong Kong's economic base, does not rely on any specific tax incentives to achieve this aim, instead it relies on its non-interventionist economic policy, low rates, and simplicity of the tax structure for providing a congenial investment climate. The standard tax rate is, for example, only 15 percent, with a 2 percent surcharge on profits of incorporated companies. There are no taxes on dividends, capital gains, wealth and gifts *inter vivos*. The tax rate is applied on a uniform basis without distinction between resident and non-resident status.

### (ii) Transfer of technology, know-how and managerial skills

The same general principle of tax neutrality applies to the transfer of technology, know-how and managerial skills.

There is however an implicit non-tax subsidy to encourage the transfer of technology. See D below.

* Reader in Economics, University of Hong Kong.

1. Officially named the Third Inland Revenue Ordinance Review Committee, appointed in 1976, of which the present writer was also a member.

### (iii) Diversification and selectivity

Again, the general principle of neutrality applies with respect to countries of origin, and types or areas of investment and trade. Since Hong Kong is itself a city-state and free port, the issues of regional areas and free trade zones do not arise.

## C. ORIENTATION OF FISCAL POLICY: SALES TAXES, EXCISE DUTIES

There is no general sales tax in Hong Kong; nor is there any general tariff due to its free port status. There is an excise duty on certain commodities, as described earlier. There are also some indirect taxes on entertainment, betting, hotel accommodation, and ownership of cars.

In the latest 1978-79 Budget, the first registration tax on semiluxury and luxury cars has been increased from the previous flat rate of 30 percent to 35 percent and 40 percent respectively, of the value of the car, while the rate of duty on imported cigarettes has been raised by HK$1.65 per pound to HK$20.15 per pound.

Taxes on betting, hotel accommodation, and private cars can be said to fall on luxury or at least non-essential consumption, while excise duties on alcohol and tobacco and entertainment tax might be held to fall on essential consumption. Taken together, however, there is no appreciable redistributive effect one way or the other.

As Hong Kong is a city-state, the question of using preferential tax rates to influence or encourage regional development does not arise.

### Trade

As Hong Kong is a free port, there is no general tariff or import duty, nor is there any general tax on exports. There is however a small levy on the total export value of clothing items and the value of all construction works undertaken in Hong Kong to finance the training of operatives and technicians in the clothing and construction industries. On the other hand, there are no specific tax incentives for either domestic or foreign trade.

## D. ORIENTATION OF FISCAL POLICY: NON-TAX FIELDS

**(i) Subsidies** — as far as direct investment is concerned, the most important non-tax incentive is the allocation of industrial land on a restricted user basis. Prior to 1973, industrialists had to compete for land at public auctions. In order to strengthen and widen Hong Kong's industrial base, a new industrial land policy has been in force since 1973 whereby capital-intensive industries that introduce higher technology and more technological skills and cannot be housed in multi-storey industrial buildings are eligible for industrial land sites by private treaty. This in effect amounts to a government subsidy on the cost of land which is very expensive in view of its scarcity in Hong Kong. As regards social infrastructure, housing and education are the two fields most heavily subsidized. Hong Kong is noted for its ambitious housing programme, and in 1977 some 1.86 million people or 41 percent of the total population lived in government-financed public housing estates at rental charges that averaged about one-third of current market rents. This programme is being expanded and it is estimated that by the mid-eighties more than three million people or some 57 percent of the projected population will be accommodated in public low-cost housing estates. In education, the government now provides free education for six years at the primary level and three years at the secondary level. In addition, a large number of private schools are also subsidized either by cash or by a land grant. Two universities, one polytechnic, and numerous technical institutes are almost wholly dependent on public funds. In the 1977-78 fiscal year, some 20 percent of total government expenditure was on education.

**(ii) Special low interest loans** — all land in Hong Kong is legally owned by the Crown, and except for land allocation through private treaty described earlier, new land is only obtainable from the government at public auctions. To give preferential treatment to industrial investment, the price for industrial sites, irrespective of the amount, can be paid either by four equal instalments over two years without interest, or by 10 percent of the price immediately after the auction and the remainder by 10 equal annual instalments bearing interest at 5 percent per annum. In the former case, the deferred payment scheme amounts to an interest-free loan, while in the latter case, the interest charged is only half of the current market rate on mortgages.

**(iii) Providing infrastructure in particular areas** — Hong Kong is a comparative laggard in the establishment of industrial estates. As stated earlier, it was not until 1973 that a new industrial land policy was formulated to allow for allocation of land by private treaty for capital- and technology-intensive industries. In 1976 an Industrial Estates Provisional Authority was formed to build industrial estates in the suburban areas of Kowloon, the peninsular part of Hong Kong. This body was subsequently taken over by the Hong Kong Industrial Estates Corporation financed entirely by public funds. Its purpose is to allocate land sites at cost to those industries that cannot be operated in the usual multi-storey buildings and to those that carry a higher level of technology than that which exists in Hong Kong at present. In early 1978, the price of land sites in such estates was about HK$45 per sq.ft., as against the market price of about HK$200 per sq.ft. At the same time, the government is also continuing its on-going policy of constructing more multi-storey factory blocks to cater for squatter workshops and small operators now housed in buildings required for public purposes. Rents in such industrial buildings are again heavily subsidized.

**(iv) Others** — as Hong Kong is already a free port, there is of course no need for the creation of free trade zones and allied facilities.

## E. EVALUATION

The tax system in Hong Kong is designed to be as neutral as possible so as to avoid any distortive effects on the economy while at the same time generating sufficient revenue to finance the government's socio-economic policies and programmes. In the words of the Financial Secretary of Hong Kong, "our tax system must be designed to meet six requirements: the first requirement is to generate sufficient recurrent revenue to finance a major part of a given level of total public expenditure (which I have set, for guideline purposes, at 88 percent) and to maintain our fiscal reserves at a statisfactory level. The second requirement is that the tax system is as neutral as possible as regards the internal cost/price structure and investment decisions. The third requirement is that the laws governing the tax system are adapted from time to time to make them consistent with changing commercial practices. The fourth requirement is that each and every levy — be it direct or indirect — is simple and easy land, therefore, inexpensive) to administer and does not encourage evasion, for a low and narrowly based tax system cannot afford to finance costly overheads. The fifth requirement is that the tax system is equitable as between different classes of taxpayers or potential taxpayers and between different income groups (and this means, *inter alia,* setting relatively high thresholds for personal taxation and generally ensuring that the system rests as lightly as possible on the disposable incomes of those at the lower end of the income spectrum, or leaves them virtually untouched). Exceptionally, and this is the sixth requirement, the tax system must be capable of being used to achieve non-fiscal objectives when necessary."[2] Judging by past experience, these requirements can already be regarded to have been largely met, though the sixth requirement is more of a contingent nature. There can be little doubt that the Hong Kong tax system contains very little, if any, disincentive effect on entrepreneurship, work effort and investment. It has proved itself capable of generating a sufficiently high proportion of government expenditure such that fiscal surpluses have been recorded in no less than 27 out of the 31 post-war fiscal years. It is estimated that the accumulated fiscal reserves are likely to reach HK$4,890 million (approximately US$1,061 million) at the financial year beginning April 1, 1978.

It is not easy, however, to evaluate precisely the role of tax plicy, since the tax effect cannot be isolated from other determinants of economic development. Nevertheless, a broad sketch of Hong Kong's macro-economic performance can at least serve as indirect evidence of the long-term effects, beneficial or otherwise, of the tax system.

Hong Kong's free port status has no doubt played a significant role in enabling the territory to grow into one of the world's top trading nations, despite its tiny size. It now ranks 18th in the list of the world's trading countries in terms of the total value of international merchandise trade, a position which is disproportionately high relative to its population. On the other hand, one should recall that this free port status dated from as early as 1842 and was more the result of a political act than a fiscal decision.

The remarkable growth and industrialization of the economy during the post-war period provides a recent and striking illustration of the positive effects of a congenial tax system. During the past three decades, the economy of Hong Kong has grown at an average annual rate of well over 8 percent in real terms. Measured at current prices, the *per capita* income of Hong Kong increased from about US$160 in 1947 to US$2,620 in 1977. This was achieved despite the fact that the population has tripled since 1945 due to the continuous influx of immigrants. In the past ten years, gross domestic capital formation has regularly accounted for well over 20 percent of the gross domestic product, and has grown at an average annual rate of over 14 percent. The economy, of course, has had its ups and downs and during the world-wide recession of 1974-75 Hong Kong's real growth rate dwindled to less than 3 percent. But the territory's resilience was such that in the recovery of 1976, it was able to achieve a staggering real growth rate of 16.9 percent. Even in 1977, when the

### APPENDIX A

**Tax revenue in Hong Kong ***

**1976-77**

| Nature of tax | Amount (million HK$) | As % of total revenue | As % of GDP | Per capita (HK$) tax |
|---|---|---|---|---|
| *Direct taxes:* | | | | |
| Profits tax — | | | | |
| Corporations | 1,479 | 19.5 | 3.1 | 332.8 |
| Unincorporated business | 233 | 3.1 | 0.5 | 52.4 |
| Salaries tax | 597 | 7.9 | 1.3 | 134.3 |
| Interest tax | 102 | 1.3 | 0.2 | 23.0 |
| Property tax | 253 | 3.3 | 0.5 | 56.9 |
| Personal assessment | 36 | 0.5 | 0.1 | 8.1 |
| Estate duty | 85 | 1.1 | 0.2 | 19.1 |
| *Indirect taxes:* | | | | |
| Rates | 619 | 8.2 | 1.3 | 139.3 |
| Excise duties | 681 | 9.0 | 1.4 | 153.2 |
| Royalties and concessions | 113 | 1.5 | 0.2 | 25.4 |
| Stamp duty | 428 | 5.6 | 0.9 | 96.3 |
| Taxes on bets, entertainment, hotel accommodation and cars | 405 | 5.3 | 0.9 | 91.1 |
| | 5,029 | 66.4 | 10.6 | 1,131.7 |

* The fiscal year is from April 1 to March 31. The Gross Domestic Product (GDP) figure is for 1976. The per capita tax revenue figures are calculated from the mid-1976 population. As at the end of 1976, US$1 = HK$4.677.

*Source:* Annual reports of the Accountant-General and Commissioner of Inland Revenue; Hong Kong Annual Report, 1977; Census and Statistics Department, Estimates of Gross Domestic Product, 1966-76.

2. The 1978-79 Budget: Speech by the Financial Secretary on March 1, 1978, para. 160 (Hong Kong: Government Information Service).

world economy was noticeably faltering, Hong Kong's real growth rate was still as high as 11.6 percent. The macro-economic record speaks for itself, and even though one cannot attribute it all to fiscal policy, the attractions of low tax rates and a simple tax system must have played their part.

Non-tax fiscal incentives, which center on industrial land — the scarce input factor in Hong Kong — have also helped. The interest-free or low-interest loans for the purchase of industrial sites have been in force for over two decades, and have helped thousand of small industrial units which are the backbone of Hong Kong's industrial structure. The new policy of allocating industrial land by private treaty and establishing industrial estates to provide land at below market prices is, however, a very recent development, and although some capital-intensive industries with a higher technological bent have been atracted, their long-term effects on the diversification of the industrial base remain to be seen.

Finally, a tax system may also be evaluated on the criterion of distributional equity. Here the verdict is less favourable. The Gini coefficient of income distribution in Hong Kong, after falling from 0.487 in 1966 to 0.411 in 1971, has ceased to decline according to the 1976 by-census. This is hardly surprising given the lack of progressivity in the tax structure as well as the absence of taxes on dividends, capital gains and wealth.

# JAPAN: Tax Structure and Fiscal Policy

by Mitsuo Sato*

## A. CATALOGUE OF TAXES AT THE NATIONAL LEVEL[1]

### Personal income tax

Payable by residents on their world-wide income, by non-residents on their income from domestic sources; progressive rates ranging from 10 to 75 percent applied to taxable income after allowing various personal exemptions; revenues account for 38 percent of total national tax revenues.

### Corporate income tax

Payable by resident juridical persons on their world-wide income, by non-residents on their income from domestic sources; rate splits as between retentions and distributions, i.e., 40 and 30 percent respectively; taxable income calculated on book profits subject to various adjustments (e.g. loss carry-over, special tax-free reserves, special accelerated depreciation, disallowances of certain expenditures, etc.); revenues account for 30 percent of total national tax revenues.

### Inheritance and gift taxes

Payable by resident heirs or legatees (or donees) on world-wide estates (or gifts), by non-residents on inheritances (or gifts) situated domestically; rates range from 10 to 75 percent; revenues account for 2 percent of total national tax revenues.

### Liquor tax

Imposed on liquors manufactured domestically or imported; mostly specific rates applied, with ad valorem rates on some luxury liquors; revenues account for 5.5 percent of total national tax revenues.

### Commodity tax

Imposed on various commodities manufactured domestically or imported; multiple ad valorem rates (5, 10, 15, 20 and 30 percent) applied, with higher rates on luxury goods; more important revenue earners are automobiles, TV sets, precious stones, air-conditioners, gramphones, refrigerators, etc.; revenues account for 4 percent of total national tax revenues.

### Gasoline tax

Imposed on gasoline manufactured domestically or withdrawn from bonded areas; a specific rate of ¥36,500 per kiloliter applied; revenues, earmarked for road construction and improvement, account for 5.8 percent of total national tax revenues.

### Other taxes

Include registration and license taxes, travel tax, securities transfer tax, LPG tax, sugar excise tax, stamp duties, admission tax, motor vehicle tonnage tax, customs duties, tobacco monopoly profits, etc.; their individual revenue importances are small, totalling 14.7 percent of total national tax revenues.

## B. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, ESTATES AND GIFTS

### 1. Investment

In general, tax policy is designed to provide neutrality between domestic and foreign investment (i.e., investment by natives and foreigners), although of course the final responsibility to achieve neutrality must lie with the investor's country of residence if one is to follow the concept of capital-export neutrality.[2] Also, tax policy consideration is that neutrality be achieved by residents between domestic and foreign investment.

As for direct investment from abroad, the same tax treatment is given to a subsidiary owned by a foreign parent as to a purely domestic corporation, since a subsidiary is regarded as a resident corporation for corporate tax purposes.[3] Thus, subsidiaries are entitled to various tax incentives designed to promote investment, such as secial tax-free reserves, special accelerated depreciation, tax credit for research and development outlays and other incentive measures, provided of course that conditions generally required are met. A small element affecting neutrality is that dividends paid out to foreign parents are subject to a withholding tax at a treaty rate of 10 percent, while domestic intercorporate dividends are tax-exempt; However, this accords with international tax practice and involves no serious distortion of neutrality if the foreign parent is given a full foreign tax credit by its country of residence.

Direct investment from abroad through a branch, though of less importance than through a subsidiary, is treated almost the same as resident corporations for general taxation and investment incentive purposes. Exceptions are that the reduced tax rate on corporate distributions (30 percent as against 40 percent on

* Director of the Research Division, Tax Bureau, Ministry of Finance.

1. Figures shown are those for the financial year 1977 (budget estimates).

2. For a relevant discussion, see Prof. Komatsu, Country Report on Differences in Tax Treatment between Local and Foreign Investors and Effects of International Treaties, Part V.

3. Corporate residence is determined by the "location of head office" rule so that a subsidiary having its head office in Japan is defined as resident in Japan.

corporate retentions) is not applied to branch profits and the tax incentive for investment abroad ("overseas investment loss reserve", see below) is not granted. The fact that no ratereduction for branch profits is given recognizes the fact that the definition of "distribution" from branch profits is technically difficult and that the neutrality between forms of business rather requires higher corporate taxes on branch profits since the subsidiary is subjected, in addition to corporate taxes, to a withholding tax on dividends paid to the parent abroad, while the branch is not.

The fact that the "overseas investment loss reserve" is not extended to a branch of a foreign company reflects the fact that the foreign branch is taxed only on its profits arising from domestic sources, i.e., it is exempt from tax on profits from investment abroad which the incentive intends to promote.

Foreign portfolio investors are subject to treaty withholding taxes on dividends (at 15 percent), interest (at 10 percent) and royalties (at 10 percent) derived from domestic sources. Whether these withholding taxes distort neutrality depends to a large extent on the tax treatment in the country of their residence. If, for instance, the country of residence recognizes the imposition of withholding taxes and provides a foreign tax credit, neutrality is much easier to achieve; if it simply disregards the withholding taxes the portfolio investment is discriminated against vis-à-vis investment at home; and if it exempts such investment income from its own taxes the investment may be favored vis-à-vis investment at home (from the viewpoint of the investors' country of residence). On the part of Japan as the source country, the unilateral withholding tax rate of 20 percent is reduced by tax treaties as indicated above so as to help the residence country to achieve neutrality.

As for investment by residents, the basic policy objective is to provide neutrality between investment abroad and at home. Thus, direct investment abroad is entitled to a tax credit for both the foreign corporate and withholding taxes, and portfolio investment abroad to a tax credit for the foreign withholding taxes. Through the working of these credit mechanisms, it is expected that income taxation will be neutral with respect to the investment location and therefore serve world efficiency.

One might argue, however, that investment at home is actually favored vis-à-vis investment abroad because most unilateral tax incentives are oriented to domestic investment. The reason for this orientation is that the tax incentives are granted on a selective basis, i.e., they are applied to specific investments that serve to achieve specific policy objectives such as environmental preservation, urban reconstruction, regional development and encouragement of small-scale enterprises.

Although such bias inherent in the incentive structure should not be overlooked, it should not at the same time be over-emphazed in view of the presence of some countervailing factors. First, there is a unilateral tax incentive specifically designed to encourage investment abroad; a corporation investing in developing countries or in the extraction of natural resources is entitled to a special tax-free reserve for possible losses involved in such investment. Certain percentages of capital invested may be deducted from taxable income and reserved for five years ("overseas investment loss reserve", Special Taxation Measures Act, § 55[4]). Moreover, income from direct investment abroad (in the subsidiary form) enjoys "tax deferral", i.e., taxation at home is postponed until the profits are repatriated as dividends to parent corporations, being subjected meanwhile only to foreign local taxation, however preferential that may be. Further, when repatriated, the so-called tax sparing credit is granted under a number of tax treaties to investment that has enjoyed tax reliefs abroad. Most tax treaties with developing countries contain provisions to that effect: Pakistan, India, Singapore, Thailand, Malaysia, Brazil, Sri Lanka, Korea, Zambia, Spain and Ireland.

On balance, therefore, the bias toward investment at home seems to have been offset to a considerable extent and the overall taxation system is largely neutral with respect to the location of investment.

### 2. Trade

Generally, income taxation does not intend to interfere with domestic and foreign trade. Namely, it neither encourages nor discourages internal or external transactions.

Former tax incentives aimed to encourage exports (special depreciation, etc.) have virtually all been eliminated, with only a minor incentive measure being provided to small- and medium-scale enterprises engaged in export businessess ("overseas market development reserve", Special Taxation Measures Act, § 20, § 54). Under the measure, certain percentages of export (or export-related) sales may be deducted from taxable profits and reserved for certain periods of time.[5] No other export incentives are provided for in the tax laws.

### 3. Transfer of technology, know-how and managerial skills

The same basic principle of tax neutrality applies to the transfer of techological knowledge and the rendering of personal services.

However, a tax incentive is conferred on the transfer abroad of patent, know-how and similar technological information as well as of copyrights. The rendering abroad of certain technical services is given the same tax incentive. Under these schemes, certain portions of income derived from such transfer or provision are deducted from taxable income subject to an overall limitation (Special Taxation Measures Act, § 21, § 58).

Royalties paid to foreigners, on the other hand, are normally subject to a 10 percent withholding tax under most tax treaties, as against no withholding tax provided for in the OECD Draft Double Tax Convention.

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4. The reserve must be recouped by one fifth per year from the sixth to tenth accounting years.

5. The reserve must be recouped by one fifth per year for the following five accounting years.

#### 4. Diversification and selectivity

As may be understood from what has been said, most tax incentives are selective rather than general, being adopted to achieve specific policy objectives at the minimum cost of tax neutrality.

Thus, they are specific as to the type and geographical location of investment. For instance, the incentives for environmental preservation are necessarily limited to anti-pollution investment, those for technological advance to research and development outlays, and those for encouraging small-scale enterprises to investment on production facilities by such enterprises. Similarly, the incentives to promote regional development are applied to investment in specific regions as those for urban reconstruction to that in urban areas.

The incentive to encourage investment abroad is specifically oriented to developing countries, and particularly to develop the extraction of natural resources. By the same token, the tax sparing credit is granted, on a treaty basis, to investment in developing countries which aim to encourage capital inflow through tax holidays and other similar measures.

### C. ORIENTATION OF FISCAL POLICY: SALES TAX, EXCISE DUTIES, CUSTOMS

#### 1. Redistribution of wealth

As indicated in the catalogue of taxes above, there is at present no general sales tax in Japan, and indirect taxation consist of various excise duties. The excise taxation purports to levy taxes in accordance with taxable capacity shown by consumption of particular goods. To this end, the rate structures of the duties are designed to be progressive, i.e., higher on more luxury consumption.

The point may best be illustrated by the rate structure of the commodity tax. As shown below, higher ad valorem rates are applied to those goods which are deemed to be more luxurious and frivolous, and lower rates to the less luxurious and more essential.

| *Rates* [6] | *Taxable commodities (selected items)* |
|---|---|
| 30 percent | Motor boats, yachts, billiard tables, rifles, watches made of precious metal, etc. |
| 20 percent | Passenger automobiles, air-conditioners, TV sets, furniture, etc. |
| 15 percent | Small passenger automobiles, small TV sets, small refrigerators, gramophones, music instruments, etc. |
| 10 percent | Radio sets, clocks and watches, perfumery, etc. |
| 5 percent | Auto-bicycles, toilet preparations, soft drinks, etc. |

A similar consideration has been given in designing the rate structure of the liquor tax, with higher rates being applied to more luxury liquors and lower rates to the less luxurious and more popular, as illustrated below.

| | | |
|---|---|---|
| "Sake": | Special class | 150% (ad valorem) |
| | 1st class | ¥ 200,400 per kiloliter |
| | 2nd class | ¥ 85,800 per kiloliter |
| Beer: | | ¥ 129,600 per kiloliter |
| Whisky [7]: | Special class | 220%, 150% (ad valorem) |
| | 1st class | 100% (ad valorem) |
| | 2nd class | 60% (ad valorem) |

The gasoline tax is imposed at a flat specific rate and therefore may have no significant effects on income redistribution. The tax is a benefit tax designed to impose a tax burden corresponding to the benefits received by users of highways and other roads.

#### 2. Employment and regional development

Basically, no specific measures have been taken to encourage employment or regional development in the field of indirect taxation. The tax rates are uniform throughout the country.

The only exception is that most indirect taxes are levied with special low rates in Okinawa prefecture. This special tax measure has been taken to avoid sudden changes in indirect tax rates before and after the return to the mainland. Disregarding minor exceptions, these special low rates are transitional, being scheduled to be raised gradually up to the level of those on the mainland during the period to 1982.

### D. ORIENTATION OF FISCAL POLICY: NON-TAX FIELDS

There are a great number of expenditure programs to encourage particular activities or to provide infrastructural facilities. They are, however, too diverse to summarize. Generally speaking, emphasis has been placed on the improvement of housing and living conditions, the promotion of education, and the encouragement of agriculture and small business.

Housing gets governmental support through both the direct public housing program and low interest loans by governmental banking institutions, while the living environment has been improved by direct government programs. Besides direct governmental provisions of educational services, private education receives subsidies and low interest loans from the Government, and students benefit from interest-free government-financed scholarship loans. Agriculture enjoys various governmental aids in the form of subsidies, low interest loans, direct public programs (irrigation, etc.), and price supports (mainly rice). Also, small businesses are granted governmental support mainly in the form of low interest loans and subsidies.

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6. Indicates tax rates applied to manufacturers' sales price, precious stones and their products being taxed at 15 percent on retailers' sales price.

7. Rates show only the ad valorem rates, i.e., there are whiskys taxed by specific rates.

## E. EVALUATION

It is quite difficult to evaluate quantitatively the effect of tax measures described above. As for the tax neutral objective, however, the general impression is that the objective has been largely attained since taxation appears to have caused no significant changes in capital movements, although of course one should be carefeul in analyzing the issue because many non-tax factors also affect capital movements. Investment has grown both at home and abroad until the early 1970's as indicated below, which would appear to suggest that the *overall* tax regime is by and large neutral with respect to the investment location. The observation, of course, does not deny that *specific* tax incentives may have had some effects on the type and location of investment to the extent that they provided more favorable tax treatments to certain forms of investment.

Rather parenthetically, it may be mentioned here that tax neutrality is defined in terms of capital-export neutrality rather than capital-import neutrality.[9] In other words, non-discrimination or *local* neutrality cannot stand on their own merit, at least from the viewpoint of world efficiency. They are valuable international tax rules only to the extent that they help to achieve capital-export neutrality which is mainly a responsibility of the investor's country of residence. This point is mentioned here in view of many Continental European arguments that appear to be based on capital-import neutrality or involve analytical ambiguities in this particular respect.

*Growth rate of investment (in percent)*

| | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 |
|---|---|---|---|---|---|---|
| Abroad [8] | 33.6 | 42.8 | 21.1 | 102.5 | 19.4 | 35.9 |
| Domestic | - 2.3 | 16.7 | 25.2 | 20.8 | 22.8 | 9.7 |

| | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 |
|---|---|---|---|---|---|---|
| Abroad [8] | - 5.1 | 172.5 | 49.4 | - 31.5 | 37.0 | 5.5 |
| Domestic | 3.9 | 11.2 | 13.9 | - 14.5 | - 3.3 | 4.2 |

8. Direct investment only.
9. For a relevant discussion, see Mitsuo Sato and Richard Bird, "International Aspects of the Taxation of Corporations and Shareholders", I.M.F. Staff Papers, Vol. XXII, No. 2 (July 1975).

### SOME MAJOR JAPANESE TAX INCENTIVES

Under Japanese corporate income taxation some tax deductible reserves may be created of which the following are important:

#### 1. Reserve for price fluctuations

The maximum amount deductible is the total book value of inventory less 97.6 percent of such book value. This percentage is 95 percent in case of listed shares and goods designated by the Ministry of Finance and 99.2 percent for unlisted securities. The reserve must be added back to the income of the next accounting year.

#### 2. Overseas market development reserve for small and medium-sized enterprises

The cost for overseas market development may be deducted if a corporation with a capital of not more than one billion Yen derives income wholly or partly from "overseas transactions". Overseas transactions are defined as (i) export or sales of goods to an exporter, (ii) processing of goods by the order of an exporter and (iii) major repairs to ships if payment is directly or indirectly made in foreign currency. The maximum amount of the reserve is a certain percentage of the proceeds of the overseas transactions in the preceding accounting year. The amount credited to the reserve must be added back to income of the next five accounting years in five equal installments. The above percentage varies between 0.85 and 2.3 percent, according to the nature of the transactions and the size of the corporation concerned.

#### 3. Reserve for overseas investment loss

If a Japanese corporation invests in shares of qualifying companies or grants loans to such companies it may place a certain amount of the investment in a tax deductible reserve. The reserve thus created may be held for five years, but from the sixth year on the reserve must be added to income in five annual installments. The qualifying corporations and the amounts which may be placed in the reserve are:

(i) *Overseas business companies*, i.e. having their main or head office in a developing country (in Europe: Cyprus, Greece, Iceland, Malta, Portugal, Spain and Turkey; in the rest of the world: all countries except Canada, South Africa, the U.S.A. and the U.S.S.R.). The amount which may be placed in the reserve is 30 percent of the investment.

(ii) *Overseas investment companies*, i.e. having their main or head office in Japan but which have been established for the purpose of investing — through equity or loan financing — in an overseas business company and are designated by the Government as making an important contribution to investment in developing countries. The amount which may be placed in the reserve is also 30 percent of the investment.

(iii) *Natural resources development companies*, i.e. corporations which are exclusively engaged in prospecting, development or exploitation of natural resources outside Japan. The amount which may be reserved is 40 percent of the investment.

(iv) *Natural resources prospecting companies*, i.e. corporations which are exclusively engaged in prospecting of natural resources. The amount which may be reserved is 100 percent of the investment.

(v) *Natural resources development investment companies*, i.e. corporations which are exclusively engaged in investing — through equity or loan financing — in a natural resources development company or investing in the development of natural resources. The amount which may be reserved is 40 percent of the investment.

(vi) *Natural resources prospecting investment companies*, i.e. corporations which are mainly engaged in investing in a natural resources prospecting company or investing in the prospection of natural resources. The amount which may be reserved is 100 percent of the investment.

In addition a corporation may, under conditions, place 7 percent of the expenditure on materials, labor, etc. used for a major construction project in a development country in a tax deductible reserve. The reserve may be held for five years but must be added back to income at the time of the completion of the project if it is completed within those five years.

# LIST OF TAX TREATIES

## Concerning comprehensive double taxation treaties on income

## The list is up to date as of March 31, 1978

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Australia | income | March 20, 1969 | English and Japanese | AP treaties<br>TAJ<br>IX UN A(1) 274 |
| Austria | income | December 20, 1961 | English | AP treaties<br>TAJ<br>SUPP. SER. Section C<br>IX UN A(1) 93<br>Treaty Series, Vol. 517, p. 156 |
| Belgium | income | March 28, 1968 | English | AP treaties<br>TAJ<br>SUPP. SER. Section C<br>IX UN A(1) 266<br>Treaty Series, Vol. 732, p. 168 |
| Brazil | income | January 24, 1967 | English, Portuguese and Japanese | AP treaties<br>BULL Supplement B 1968<br>TAJ<br>IX UN A(1) 191 |
| Protocol | income | March 23, 1976 | | |
| Canada | income | September 5, 1964 | English and Japanese | AP treaties<br>TAJ |
| Czechoslovakia * | income | October 11, 1977 | English | AP treaties<br>SUPP. SER. Section C |
| Denmark | income | February 3, 1968 | English | AP treaties<br>SUPP. SER. Section C<br>TAJ<br>Treaty Series, Vol. 657, p. 4 |
| Egypt (U.A.R.) | income | September 3, 1968 | English | AP treaties<br>TAJ |
| Finland | income | February 29, 1972 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 300<br>TAJ |
| France | income | November 27, 1964 | French and Japanese | AP treaties<br>SUPP. SER. Section C |
| German Federal Republic | income | April 22, 1966 | English, German and Japanese | AP treaties<br>SUPP SER. Section C<br>IX UN A(1) 163<br>Treaty Series, Vol. 682, p. 135<br>TAJ |

* Not yet in force.

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| India | income | January 5, 1960 | English | AP treaties (text as amended)<br>TAJ<br>IX UN A(1) 46 |
| Supplementary Protocol | income | April 8, 1969 | English | |
| Exchange of notes | exchange of information | November 30, 1974 | English | |
| Ireland | income | January 18, 1974 | English | AP treaties<br>TAJ<br>SUPP. SER. Section C |
| Italy | income | March 20, 1969 | English, Italian and Japanese | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 275<br>TAJ |
| Korea, Republic of | income | March 3, 1970 | English | AP treaties<br>TAJ |
| Malaysia | income | January 30, 1970 | English | AP treaties<br>TAJ<br>IX UN A(1) 282 |
| Netherlands | income | March 3, 1970 | Enlish, Dutch and Japanese | AP treaties<br>TAJ<br>SUPP. SER. Section C<br>Treaty Series, Vol. 760, p. 95 |
| New Zealand | income | January 30, 1963 | English and Japanese | AP treaties (text as amended)<br>TAJ<br>386 (BULL) 1964<br>Treaty Series, Vol. 517, p. 183 |
| Supplementary Protocol | income | March 22, 1967 | English and Japanese | TAJ<br>Treaty Series, Vol. 614, p. 324 |
| Norway | income | May 11, 1967 | English | AP treaties<br>TAJ<br>SUPP. SER. Section C<br>IX UN A(1) 192<br>Treaty Series, Vol. 683, p. 3 |
| Pakistan | income | February 17, 1959 | English | AP treaties (text as amended)<br>TAJ |
| Supplementary Protocol | income | June 28, 1960 | English | TAJ |
| Romania | income | February 12, 1976 | English | AP treaties<br>TAJ<br>SUPP. SER. Section C |
| Singapore | income | January 29, 1971 | English | AP treaties<br>TAJ<br>IX UN A(1) 283 |
| Spain | income | February 13, 1974 | English, Spanish and Japanese | AP treaties<br>TAJ<br>SUPP. SER. Section C<br>IX UN A(1) 338 |
| Sri Lanka | income | December 12, 1967 | English, Sinhala and Japanese | AP treaties<br>24 (BULL) 1970 Supplement B 1970<br>Treaty Series, Vol. 683, p. 91 |

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Sweden | income | December 12, 1956 | English | AP treaties (text as amended)<br>SUPP. SER. Section C (text as amended)<br>VII UN 164 |
| Supplementary Protocol | income | April 15, 1964 | English | TAJ<br>IX UN A(1) 155 |
| Switzerland | income | January 19, 1971 | English, German and Japanese | AP treaties<br>SUPP. SER. Section C<br>TAJ |
| Thailand | income | March 1, 1963 | English | AP treaties |
| United Kingdom | income | February 10, 1969 | English and Japanese | AP treaties<br>TAJ<br>SUPP. SER. Section C<br>IX UN A(1) 240<br>Treaty Series, Vol. 778, p. 4 |
| U.S.A. | income | March 8, 1971 | English and Japanese | AP treaties<br>BULL Supplement C 1972<br>IX UN A(1) 285<br>TAJ |
| Zambia | income | February 19, 1970 | English and Japanese | AP treaties<br>TAJ |

**Abbreviations:**

| | |
|---|---|
| AP treaties | = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation). |
| BULL | = Bulletin for International Fiscal Documentation. |
| SUPP. SER. Section C | = Supplementary Service to European Taxation, Section C. |
| TAJ | = Tax Agreements with Japan, Ministry of Finance, Tokyo. |
| Treaty Series | = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French, as the case may be. |
| UN | = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes. The indication VII UN 164 means: United Nations, Volume VII, page 164. |

# REPUBLIC OF KOREA:
# Tax Structure and Fiscal Policy

By Chang-Shick Ahn*

## A. CATALOGUE OF TAXES AT THE NATIONAL LEVEL

### Personal income tax

The individual income tax is levied at progressive rates ranging from 8 to 70 percent on the basis of world-wide income of an individual domiciled in Korea or of an individual who has resided there for a period longer than one year without a domicile in Korea (resident taxpayer). Non-resident taxpayers are only taxable on the basis of source principle, i.e. on Korean-source income. Capital gains, retirement income and income from forestry are subject to schedular taxaton, and are thus outside the scope of global income taxation.

### Corporate income tax

The corporate income tax (corporation tax) is levied on all profits from all sources of ordinary domestic corporations and on profits arising from designated profit-making business of public welfare associations. In the case of foreign corporations, only profits arising from sources in Korea are subject to the corporation tax. The corporation tax is levied at rates of 20, 30 and 40 percent according to the amount of taxable income. Special reduced rates ranging from 20 to 33 percent are applicable to open corporations or non-profit corporations.

### Inheritance and gift taxes

The inheritance tax is assessed on the total value of property comprising the inheritance plus the value of any property given to any person within one year before the date of death at rates from 10 to 70 percent. The gift tax is assessed on the value of the gift received at a rate schedule similar to that of inheritance tax.

### Assets revaluation tax

The assets revaluation tax is imposed at a rate of 3 percent on corporations or individuals who have revalued their assets. The assessment basis is the reappraisal gain less the amount of losses carried over.

### Excess profits tax

The excess profits tax is levied for the purpose of price stability at a rate of 100 percent of the profits which are in excess of the prices fixed by the government.

### Value added tax

The statutory rate of the value added tax which replaced previous indirect taxes — such as the business tax, commodity tax, textile products tax, petroleum products tax, electricity and gas tax, entertainment and food tax, travel tax, and admission tax — from July 1, 1977 is a single flat rate of 13 percent. However, this rate is flexible in that it may be adjusted within a range of 3 percentage points. Thus, the VAT rate currently in force is 10 percent. To mitigate the regressive effect of the VAT system, the special excise tax is imposed at rates ranging from 10 to 160 percent on specific luxury goods, etc.

### Other indirect taxes

Other indirect taxes such as the liquor tax (10-200 percent), telephone tax (15 percent), and the lump sum stamp tax are rather minor ones in terms of revenue production.

### Customs duties

The customs duties are assessed on the basis of price or quantity of imported goods. The tariff rates vary from a minimum of zero (duty free) to a maximum of 150 percent based on the tariff table. When it is considered necessary from the standpoint of the national economy to protect major domestic industries or to prevent the importation of specific goods, the government may increase the tariff rate by up to 50 percent of the basic tariff rate, and when it is considered necessary to import specific goods or to prevent increasing prices as a result of monopoly, the government may lower the tariff rate down to 50 percent of the basic tariff rate.

### Defense tax

The defense tax is aimed at securing financial resources required for national defense on the principle of universal tax payment by every national. Under the defense tax law, the taxpayers of most internal taxes, customs duties and local taxes are liable to the tax at rates ranging from 2.5 to 30 percent on the basis of the relevant tax amount and import prices, etc. The defense tax is a kind of tentative national surtax as it is levied for a period of 5 years up to 1980 on top of the respective tax amount concerned.

## B. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, INHERITANCE AND GIFTS

### (1) Investment

Although the Korean economy is growing there is still much room for development and the government continues to provide ample investment opportunities to foreign as well as domestic investors. A high rate of investment is essential in order to sustain Korea's continuing development, and thus related policies are

* Director International Tax Affairs Division, Tax System Bureau.

Revenue production by tax item and the breakdown into percentages of total revenue and of GNP are summarized as follows:

(in million won)

| | 1976 | | | 1977 (Budget) | | |
|---|---|---|---|---|---|---|
| GNP | 12,143,360 | | | 15,096,800 | | |
| Total tax revenue 1 | 2,269,113 | | | 2,830,370 | | |
| | Tax revenue | % of total tax revenue | % of GNP | Tax revenue | % of total tax revenue | % of GNP |
| ***Direct taxes:*** | 348,081 | 24.2 | 4.5 | 685,771 | 24.2 | 4.5 |
| Income tax | 319,021 | 14.1 | 2.6 | 403,913 | 14.3 | 2.7 |
| Corporation tax | 171,172 | 2.5 | 1.4 | 262,366 | 2.3 | 1.7 |
| Inheritance & gift tax | 9,904 | 0.4 | 0.1 | 13,913 | 0.5 | 0.1 |
| Assets revaluation tax | 7,881 | 0.3 | 0.1 | 5,479 | 0.2 | – |
| Registration tax | 40,018 | 1.8 | 0.3 | – | – | – |
| Excise profits tax | 85 | – | – | 100 | – | – |
| ***Indirect taxes:*** 2 | 784,251 | 34.6 | 6.1 | 1,002,905 | 35.5 | 6.6 |
| Value added tax | – | – | – | 218,224 | 7.7 | 1.4 |
| Special excise tax 3 | – | – | – | 113,689 | 4.6 | 0.8 |
| Liquor tax | 93,020 | 4.1 | 0.8 | 128,728 | 4.5 | 0.9 |
| Telephone tax | 13,829 | 0.6 | 0.1 | 18,648 | 0.7 | 0.1 |
| Stamp tax | 14,603 | 0.6 | 0.2 | 16,599 | 0.6 | 0.1 |
| Business tax | 261,404 | 11.5 | 2.2 | 213,254 | 7.5 | 1.4 |
| Commodity tax | 166,422 | 7.3 | 1.4 | 123,903 | 4.4 | 0.8 |
| Textile products tax | 54,066 | 2.4 | 0.4 | 28,612 | 1.0 | 0.2 |
| Petroleum products tax | 142,276 | 6.3 | 1.2 | 104,548 | 3.7 | 0.7 |
| Travel tax | 21,262 | 0.9 | 0.2 | 15,348 | 0.5 | 0.1 |
| Electricity & gas tax | 6,038 | 0.3 | – | 13,643 | 0.5 | 0.1 |
| Admission tax | 11,341 | 0.5 | 0.1 | 7,659 | 0.3 | 0.1 |
| ***Customs duties*** | 275,512 | 12.1 | 2.3 | 338,164 | 11.9 | 2.2 |
| ***Defense tax*** | 268,703 | 11.8 | 2.2 | 309,174 | 10.9 | 2.0 |
| ***Monopoly profits*** | 178,000 | 7.8 | 1.5 | 220,000 | 7.8 | 1.5 |
| ***Local taxes*** | 214,566 | 9.5 | 1.8 | 274,356 | 9.7 | 1.8 |

1. Revenue of previous year is excluded.
2. VAT and special excise tax have been put into force from July 1, 1977 instead of business tax, commodity tax, textile products tax, petroleum products tax, travel tax, electricity and gas tax, admission tax, and entertainment and food tax.
3. Entertainment and food tax revenue (19.628 mil won) is included in the special excise tax revenue. The entertainment and food tax was incorporated into local taxes from July 1, 1977.

designed to offer a favorable climate for, and to encourage investment in, production and services.

Particular emphasis has been given on the promotion of the so-called strategic industries such as machinery, shipbuilding, electronic and chemical industries, etc, in order to establish an extensive production structure and to modernize the national industry.

Korea's basic policy toward the inducement of foreign private capital is laid down in the Foreign Capital Inducement Law promulgated on March 12, 1973 (Law No. 2598), under which major tax concessions favorable to foreign investment are provided.

In accordance with the provisions of the Law, a foreign investor may own up to 100 percent of the stocks or shares of a domestic enterprise. The Korean government shall, in granting such authorization or approval, give priority to those projects which will substantially contribute to the improvement of the balance of payments, and also to joint ventures.

Enterprises financed through foreign equity are entitled to exemption from and reduction of taxes. Full exemption is allowed for a period of five years, and a 50 percent reduction is given for the following three years, for individual and corporate income taxes, property tax, and property acquisition tax based on the ratio of the stocks or shares owned by the foreign investors concerned to the total stock or shares of the enterprise. Also, a similar tax exemption and reduction is allowed with respect to dividend income distributed by the enterprise to its foreign shareholders. With respect to individual income tax or corporation tax on the interest or other income accruing to the lender from a cash loan contract or a capital or capital goods inducement contract, full exemption is allowed for the entire period of the loan outstanding.

In case an investment in land is made for the establishment of a (partially) foreign owned enterprise it is exempt from the capital gains tax under the Foreign Capital Inducement Law.

To encourage such strategic industries as shipbuilding, machinery, electronic and chemical industries, etc., domestic enterprises are allowed, under the Foreign Capital Inducement Law, to elect one of the following tax incentives:

1. full exemption of income tax or corporation tax for three years and 50 percent reduction for two years thereafter;
2. investment tax credit of 8 percent (or 10 percent); or
3. 100 percent special depreciation.

### (2) Trade

The major element of the extraordinary expansion and transformation of the structure of Korean economy has been the rapid growth of exports. The government has given stronger tax incentives to encourage foreign trade.

Under the Income Tax Law and Corporation Tax Law, various tax free reserves are allowed for a business, earning foreign exchange such as reserves for overseas market development of 1 percent of foreign exchange earnings, reserves for export loss of 1 percent of foreign exchange earnings or 50 percent of the income therefrom, reserves for overseas investment loss of 10 percent of the investment amount, and reserves for price fluctuation of 5 percent of the value of inventory goods.

In addition to businesses earning foreign exchange a 30 percent special depreciation for fixed assets is allowed in accordance with the provisions of the Income Tax Law and Corporation Tax Law.

### (3) Transfer of technology, know-how and managerial skills

Along with the quantitative expansion of the GNP, there has been a significant qualitative shift in the industrial structure. It is the fundamental policy of the government to encourage actively the introduction of advanced technology into the Korean economy, and the government provides more tax incentives to the capital intensive or technology intensive industries for the modernization of the industrial structure than to labor intensive industries.

With respect to income tax on unincorporated enterprises or corporation tax on incorporated enterprises which is normally imposed on remuneration payable to an alien or foreign juridical person providing technology under a technology assistance contract, full exemption is allowed for a period of five years from the date on which the technology assistance contract is approved by the government and a 50 percent reduction is granted for the subsequent three years according to the Foreign Capital Inducement Law.

Foreign individuals employed by enterprises (partially) owned by foreigners and foreigners furnishing labor under a technology assistance contract in conformity with the Foreign Capital Inducement Law are exempt from the wage and salary income tax for five years in proportion to the percentage of the total amount of wage and salaries as against that of the global income under the Income Tax Law.

### (4) Diversification and selectivity

There are no legal provisions for different tax treatment as to countries in respect to foreign investment and trade, etc.

Special tax concessions are given to the agriculture, fishery and livestock industries. In brief, the previous business tax imposed on the selling or processing of agricultural products was waived, and as to the livestock industry, full exemption of income tax or corporation tax is applied for a period of 4 years and 50 percent reduction for the subsequent 2 years is granted under the Tax Exemption and Reduction Control Law. The previous business tax granted an exemption with respect to the selling or processing of fishery products without a place of business.

To encourage the movement of enterprises which carry on business in big cities to other areas, the Tax Exemption and Reduction Control Law provides a tax free reserve scheme for movement and an investment tax credit of 8 percent (or 10 percent in the case of using domestic materials).

In case an enterprise moves to a certain area which is designated by the government for the purpose of nation wide optimum development, the tax incentives granted to such strategic industries as machinery, shipbuilding, chemical and electronic industries, etc. are applied mutatis mutandis under the Tax Exemption and Reduction Control Law. Those strategic industries are allowed to elect one of three tax incentives:

1. full exemption of income tax or corporation tax for three years and 50 percent reduction thereafter for two years,
2. investment tax credit of 8 or 10 percent, or
3. 100 percent special depreciation.

When an enterprise exports goods to a country which imports Korean goods amounting to less than 10 percent of total Korean exports, special reserves for overseas market development are allowed up to 2 percent of foreign exchange earnings as compared with the reserve of 1 percent in other cases.

## C. ORIENTATION OF FISCAL POLICY: SALES TAXES, EXCISE DUTIES, CUSTOMS

### (1) (Re)distribution of wealth

One feature of the value added tax system which was introduced as of July 1, 1977, and which is a kind of general sales tax, is its economic neutrality. However, in the value added tax mechanism, the tax burden is passed on to the final consumers and regressivity of the value added tax burden is inevitable. To prevent this regressivity of the value added tax, the law provides a broad scope of tax exemptions with respect to the necessities of life, etc. The Special Excise Tax Law provides special high rate taxation on luxury items and expensive durable goods. This law also contributes to the mitigation of the regressive effect of the value added tax.

Usually the value added tax does not constitute a burden on traders. However, in the case of small traders, some unexpected circumstances might take place in which the value added tax burden cannot be passed on to the next traders or to final consumers. Consequently, the trader must himself bear the tax burden. For these cases the government provides some administrative relief measures of the unexpected additional tax burden through rational adjustment of the "standard profit rate" to be decided by the government.

The items which are exempted from the value added tax under the current Value Added Tax Law are basic necessities of life and services, social welfare services such as medical and health services, educational services, goods or services related to culture, certain personal services and production factors, etc.

A Special excise tax is imposed mainly on luxury goods and expensive durable goods at rates ranging from 10 to 160 percent.

On the importation of luxury consumption goods (e.g., perfume, valuable watches, diamonds, etc.), high rates of customs duties varying from 100 to 150 percent are applied, and the importation of basic raw materials and necessities of life (e.g., crude oil, ore, flour, etc.) and the items donated for the purpose of relief or charity are duty free.

### (2) Employment

There are no direct support measures in the field of indirect taxation to increase employment. However, the government induces the indirect promotion effect on the increase of employment through the encouragement of investment and exportation under the value added tax system and the Customs Duties Law.

A consumption type value added tax is not usually imposed on capital investment, and exportation is zero-rated, which would lead indirectly to the increase of employment. The customs duties imposed on such capital goods to be used in key industries (e.g., chemical, machinery, electronic, electric industries, etc.) are reduced under the Customs Duties Law and the customs duties imposed on the raw materials to be used for the production of export goods are refunded under the "Special Law for Drawback of Customs Duties and Taxes".

### (3) Regional development

The government gives no special tax concessions in the field of indirect taxation for the encouragement of regional development. The only exception is the exemption of the value added tax under certain conditions according to the Tax Exemption and Reduction Control Law respecting houses and their sites which are located in "development areas" designated by the Minister of Construction for the promotion of development in certain areas.

## D. ORIENTATION OF FISCAL POLICY: OTHER (NON-TAX) FIELDS

### (1) Subsidies

At the moment, there are no budgetary support measures in the form of subsidies given to the private sector instead of general tax concessions.

### (2) Special low interest loans

Financial policies are geared to build a stable economic foundation and to eliminate inflationary pressures. Basic monetary policy is focused on the management of aggregate demand through money and credit control, efficient mobilization of national savings, and strengthening selective finance for priority sectors of the economy.

The government applies no differentiated treatment in giving financial credits to either (partially) foreign owned and local business firms.

The government plans and directs the distribution of funds supplied by general budgetary resources and the National Investment Fund so as to ensure adequate finance for the development of the infrastructure, and of the basic energy, chemical, food production and heavy industries. It also ensures that appropriate amounts of savings made through financial institutions are channeled to the export sector, to small and medium size enterprises and house buyers.

Special low interest financial support is given to the heavy and chemical industries and export industry for the effective financing required for capital investment. The government provides preferential treatment to the projects which use domestic materials. A special loan scheme for medium industries is also established.

The special interest rate of financial loans to the machinery industry is 13 percent per annum and eligible enterprises are those which arry on a business designated by the President of the Bank of Korea and registered in accordance with the "Promotion Law of Machinery Industry".

Short term export loans are provided at the rate of 8 percent, and in the case of middle and long term loans, the interest rate is the LIBO rate for six months plus 2.0 percent. The interest rates applicable to construction business carried on abroad range from 13 to 15 percent.

The interest rates of financial loans to medium industries are 13 or 14 percent. Ordinary interest rates are comparatively high by western standards and range up to 16 percent. Under the pertinent regulations, commercial banks are placed under the obligation to grant loans to medium sized industries. The ratio of compulsory loans is prescribed to be over 30 percent of loan increment in the bank concerned.

### (3) Providing infrastructure in particular areas (e.g. industrial estates)

To keep pace with rapid economic development, the government is actively promoting the construction of industrial estates. There are now two free export zones, six industrial export estates, one special industrial export estate, eleven local industrial estates, two private industrial estates, and five heavy and chemical industrial estates, totaling twenty-seven industrial estates with a combined area of 26,422 acres. Furthermore, in order to develop heavy and chemical industries, development programs for the petro-chemical industrial complex and machine industry complex have been established. Also, along with the expansion of the country's economic scale, and in order to accommodate the increasing requirement for industrial estates, additional new industrial estates will be developed along with the expansion of existing estates.

All the industries located in an industrial estate enjoy general advantages such as low land costs, adequate power and water supplies, good road networks, various supporting facilities including special administrative support. There are also other public facilities such as customs offices, banks, immigration offices, labor offices, quarantine, post offices, etc. Most important, however, are the tax concessions granted to foreign enterprises under the Foreign Capital Inducement Law.

Surrounded by sea, Korea possesses harbors, and the industrial estates in most cases have their own harbor facilities equipped with cargo handling capacity. The expansion of an expressway network has made it possible to connect nearly every district and industrial estate of the country and thus to provide a "one-day" travel network.

Furthermore, all major urban areas are connected by railroad, and electrification of the railroad system is expanding. The container transportation system has been put into operation and has remarkably facilitated transportation by land, air and sea.

Foreign investors may either own or lease land throughout Korea. Foreign nationals are subject to the regulations of the Alien Land Law which requires that (partially) foreign owned enterprises with more than 50 percent foreign ownership of stocks or shares obtain approval for land ownership from the Ministry of Home Affairs. Bonded warehouses and factories may be established at any point in the industrial estates with the approval of the Office of Customs Administration.

(4) **Others (e.g. the creation of free trade zones and allied facilities)**

At present there are two free export zones; one is the Masan Free Export Zone which was established in 1970, and the other is the Iri Free Export Zone, established in 1973. These two zones are special tax free areas having the characteristics of bonded areas where the application of various pertinent laws and regulations has been waived or relaxed altogether or in part. A free export zone is a specially designated industrial area where (partially) foreign owned enterprises can manufacture, assemble, or process export products using freely imported tax-free raw materials and semi-finished goods.

Joint ventures of foreign and Korean investors or entirely foreign owned ventures and enterprises of a highly technical and labor-intensive nature with definite prospects for exporting are eligible types of enterprises for the free export zone.

Administrative procedures concerning foreign investment, joint ventures, approval of occupancy and plant construction are simplified under the control of the Office of Industrial Estates Administration. Various necessary support and service facilities such as transportation, stevedoring, packing, repair and maintenance of machines and tools and other common facilities needed by occupants are available in the free trade zones.

## E. EVALUATION

Beginning from a position close to the bottom of the international income scale and without benefit of significant natural resources, Korea launched itself upon a bold series of economic development programs which in less than fifteen years have transformed the country from a marginally subsistent agricultural economy into one of Asia's major industrial nations. By 1976 real GNP, growing at 9.8 percent per annum since 1962, had risen from $3.9 billion to $15.3 billion in 1970 prices; while per capital GNP, in current prices, has increased from $87 to $698 which is one of the highest rates of growth in modern economic history.

Though Korea's rapid growth has clearly been the result of a number of interacting economic, political and social factors which cannot be easily quantified, certain key elements can be singled out. The nation's commitment to industrialization, while it was to a large extent dictated by circumstances, also reflected the fact that Korea did possess a very important resource: its well educated, highly motivated and industrious populace.

Among the tactical factors involved in Korea's remarkable growth, the key role played by an active development strategy and export expansion stands out. The development strategy has certainly been characterized in granting tax and non-tax incentives effectively to the key industries in view of national economy. Especially, Korea's tax concessions for foreign investment are most attractive compared with those of the Southeast Asian countries.

A survey was conducted to find out the motives of foreign investments in Korea, which disclosed that foreign investment in most cases was made because of such advantages as an abundant labor force, well furnished industrial sites, and tax privileges.

### LIST OF TAX TREATIES

**Concerning comprehensive double taxation treaties on income/capital**
**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Belgium * | income | August 29, 1977 | ** | |
| Canada * | income | February 10, 1978 | English, French and Korean | AP treaties |
| German Federal Republic * | income, capital | December 14, 1976 | English, German and Korean | AP treaties<br>SUPP. SER. Section C |
| Japan | income | March 3, 1970 | English | AP treaties |
| United Kingdom * | income | April 21, 1977 | English and Korean | AP treaties |
| U.S.A. * | income | June 4, 1976 | English and Korean | AP treaties |

* Not yet in force.
** Not yet published.

**Abbreviations:**
AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation).
SUPP. SER. Section C = Supplementary Service to European Taxation, Section C.

# SINGAPORE:
# Tax Structure and Fiscal Policy

**by Lee Fook Hong, FCIS, FAIA**

## A. CATALOGUE OF TAXES IMPOSED

Singapore is a small country of about 600 square kilometers with 54 islets. The main island is about 42 kilometres in length and 23 kilometers in breadth. It was once a British Colony. Since the end of the Second World War, there have been significant political, social and economic developments. From a Crown Colony, Singapore advanced to a self-governed state. On August 9, 1965 on separation from Malaysia, Singapore was declared a Republic, with a President as its constitutional Head and thus became a fully independent democratic and sovereign nation. Singapore has a multi-racial population. At June 30, 1976, the population was estimated at 2,278,200 persons.

Singapore's role as a regional trading centre has long been recognised because of its well-established infrastructure. Over the years its communications, banking and business acumen have become highly developed. To encourage the setting up of local industries and export-oriented industries, the Government launched an industrialisation programme in the 1960's. With the growth of manufacturing activities and export-oriented enterprises, the scope of domestic and international financial services has also expanded. With prudent and sound monetary policies coupled with political and economic stability, Singapore's additional role in international finance has become increasingly important. She has now evelved as a major financial centre for South East Asia.

To accelerate the growth of the manufacturing and export-oriented industries and in line with the policy of developing Singapore into a major financial centre, the tax system has been geared to attract not only local but also foreign investors. The Government of Singapore imposes the following taxes:

| *Name of taxes* | *Tax legislation* | *Chapter* |
|---|---|---|
| Inland Revenue Department: | | |
| Income tax | Income Tax Act | 141 |
| Property tax | Property Tax Act | 144 |
| Estate duty | Estate Duty Act | 137 |
| Payroll tax | Finance (Payroll Tax) Act | 139 |
| Betting & sweepstakes duties | Betting & Sweepstakes Duties Act | 131 |
| Private lotteries duties | Private Lotteries Act | 143 |
| Rubber estates assessments | Rubber Estates Assessments Act (up to 31.1.75) | 145 |
| | Property Tax Act (w.e.f. 1.1.76) | 144 |
| Stamp duty | Stamp Act | 147 |
| Radio & television licence fees | Broadcasting & Television Act | 83 |
| Customs & Excise Department: | | |
| Customs duties | Customs Act | 133 |
| Film hire duty | Cinematograph Film Hire Duty Act | 132 |
| Entertainment duty | Entertainment Duty Act | 136 |
| Cess on hotel rooms & sale of foods & drinks | Tourist Promotion (Cess Collection) Act | 205 |
| Motor vehicle taxes & road tax | Customs Act & Motor Vehicles (Registration & Licensing) Rules, 1972 | |

There is no capital gains tax, turnover tax, sales tax, value added tax, development tax, wealth tax, gifts tax or surtax on imports.

### Income tax

Income tax is chargeable on all incomes earned in or remitted to Singapore. Income which is taxable includes:

1. Gains or profits from any trade, business, profession or vocation;
2. Gains or profits from any employment;
3. Dividends, interest or discounts;
4. Any pension, charge or annuity;
5. Rents, royalties, premiums and other profits arising from property including the net annual value of properties used by the owner or occupied rent free for residential purpose. (An individual taxpayer is exempt from tax on the net annual value of one residence owned and occupied by him, but any excess over and above the N.A.V. of $25.000/— is subject to tax. The exemption is limited to one property).
6. Gains or profits of an income nature not falling within any of the preceding items.

Gifts, legacies, lottery winnings and capital gains are not regarded as income and are not chargeable to income tax.

Singapore income tax is levied on a territorial basis. Both residents and non-residents are chargeable to tax on —

(a) Income accruing in Singapore, or
(b) Income derived from Singapore.

A resident in Singapore is also chargeable to tax on income received in Singapore, but a non-resident is not liable to tax on income remitted to Singapore from outside Singapore.

For individuals resident in Singapore the tax rate varies from 6 to 55 percent on chargeable income. For companies the tax rate is 40 percent but shareholders receiving dividends are allowed tax "set-off" for the amount of tax deducted at source from the dividends. A refund may be claimed where the amount of tax deducted from dividends exceeds the tax payable by shareholders.

* Principal consultant, Lee Fook Hong & Co., Chartered Secretaries & Management Consultants, Republic of Singapore.

Individuals who are not resident in Singapore are not entitled to personal reliefs and their income is generally charged to tax at 40 percent unless they are entitled to non-resident reliefs. Non-resident reliefs are granted to certain categories of non-resident individuals.

Tax incentives are provided for under the Economic Expansion Incentives (Relief from Income Tax) Act. They are —

(a) Tax exemption for a five-year period;
(b) Special deductions for additional plant and machinery and exemption from tax on dividends from expanding enterprises;
(c) Exemption from tax for a period of up to 15 years on increased export earnings;
(d) Exemption from tax on interest payable to non-residents on approved loans or credit facilities for productive equipment;
(e) Reduction of or complete exemption from tax on approved royalties, technical assistance fees or contributions to research and development.

Offshore income derived by Asian Currency Unit is taxed at the concessional rate of 10 percent instead of the normal 40 percent. Exemptions are also granted under the Income Tax Act on —

(a) Income from ocean-going vessels registered in Singapore;
(b) Interest derived by non-residents on deposits with approved banks;
(c) Interest from Post Office Savings Bank;
(d) Interest from Asian Dollar Bonds.

**Property tax**

Property tax is levied on immovable properties. It is payable half-yearly in January and July. This tax is based on the annual value of all houses, lands, buildings and tenements. Exemption from property tax is granted on —

(a) Properties with an annual value of $18/— or less, and
(b) Buildings or parts thereof used exclusively for religious, educational or charitable purposes.

The rate of property tax varies from 12 to 36 percent, depending on the locality.

**Estate duty**

Estate duty is levied at graduated rates, upon the principal value of property, which passes on death, based on the open market value at the time of death. Property liable to Estate duty includes: —

(a) All property of a deceased person situate in Singapore, whether movable or immovable, settled or not settled, which passes or is deemed to pass on death;
(b) In the case of persons domiciled in Singapore, all movable property situate abroad.

No duty is levied if the total value of the state is $100,000 or less. In other cases, the balance of the estate is liable to estate duty from 5 to 60 percent but a remission of duty of 90 percent on the next $20,000 and declining by 10 percent for every $20,000 thereafter is granted.

**Payroll tax**

Payroll tax is levied at the rate of 2 percent on the total payroll of an employer carrying on a trade, business or vocation where the total payroll exceeds $500/— for each month. The tax is applicable to the whole of the remuneration, including salaries, wages, commission, bonuses, allowances, leave pay, directors' fees and other emoluments paid in cash to employees. Benefits in kind such as the value of free accommodation provided to employees are excluded.

**Betting & sweepstakes duties**

Betting and sweepstakes duties are levied on bets made on —

(a) Any totalisation or pari-mutuel; and
(b) Every sweepstake promoted by any racing club or association.

The duty on bets is 10 percent of the amount of the bets. In the case of sweepstakes the duty is 30 percent of the amount contributed towards the sweepstakes.

**Private lotteries duty**

Private lotteries duty is payable on lotteries promoted by private clubs or societies and restricted to members. A permit issued by the Commissioner of Estate Duties is required to promote such lotteries. Such permits are granted on the following conditions: —

(a) No profit shall accrue to any individual; and
(b) No commission whatsoever shall be paid for the sale of such tickets.

The duty on lotteries is 30 percent of the gross proceeds and it is payable by the promoters.

**Rubber estates assessments**

Rubber estates duty is payable quarterly or yearly. For duty purposes, there are two categories of estates: —

(a) 40.5 hectares and above (Duty is based on production).
(b) Under 40.5 hectares (Duty is based on number of trees).

The Rubber Estates Assessment Act, Chapter 145 and the Rubber Estates (Surcharge on Assessment) Act, Chapter 146 were repealed on 1.1.76. As from that date all rubber estates are assessed under the Property Tax Act.

**Stamp duty**

Stamp duty is imposed on various kinds of instruments, both commercial and legal. The rate of duty varies from one type of instrument to another. It ranges from 10 cents an instrument to a percentage of the value of the subject of the document.

**Radio & television licence fees**

A licence is required to enable the licensee to use a radio or television receiver. A dealer's licence is required for any person who sells a radio or television set or similar apparatus for transmission or broadcasting. The licence fees are as follows:

| | |
|---|---|
| Radio Licence | $12 per annum |
| Television Licence | 36 ,, ,, |
| Dealer's Licence | 25 ,, ,, |

In the case of hotels in which not less than 75 percent of the total number of rooms have radio or television sets installed, a concessionary rate of $18/— per annum is granted.

### Customs duties

The Customs and Excise Department is responsible for the collection of customs duties, both import and excise, licence fees and other charges payable under the Customs Act and other subsidiary legislation.

Singapore is essentialy a free port. Out of over 2,000 items in the trade classification, only 200 including liquor, tobacco and petroleum products are subject to duty.

There are no duties on goods exported from Singapore.

### Film hire duty

Film hire duty is levied under the Cinematograph Film Hire Duty Act, Chapter 132. The rate of film hire duty is one-quarter of 60 percent of gross receipts derived or deemed to have been derived from film renting.

### Entertainments duty

Entertainments duty is payable under the Entertainments Duty Act, Chapter 136. Such duty is normally collected from cinemas, amusement parks, professional sports and miscellaneous shows.

### Cess on hotel rooms & sale of funds & drinks

A 3 percent cess is payable on hotel rooms and on the sale of food and drinks in tourist establishments under the Tourist Promotion (Cess Collection) Act, Chapter 205.

The Customs & Excise Department undertakes the collection of such cess on behalf of the Singapore Tourist Promotion Board (STPB).

### Motor vehicles taxes

A 125 percent ad valorem tax known as Additional Registration Fee (A.R.F.) is levied on all new cars. In addition to A.R.F. imported new cars are subject to 45 percent ad valorem duty.

For road tax there is a sliding scale up to a maximum of 80 cents per c.c. for private cars over 3000 c.c. In the case of company cars the tax is double. In addition, there are registration fees and licence fees.

## TOTAL REVENUE COLLECTION

### (i) Inland revenue department's collection by source

| | *($'000)* 1975 | 1976 |
|---|---|---|
| Income tax | 1,123,745 | 1,153,559 |
| Property tax | 278,736 | 330,337 |
| Property tax surcharge | 2,703 | 1,488 |
| Stamp duty | 46,933 | 56,848 |
| Payroll tax | 51,805 | 59,302 |
| Estate duty | 21,634 | 21,851 |
| Betting & sweepstake duty | 19,486 | 24,365 |
| Radio & T.V. licensing | 11,327 | 12,220 |
| Private lotteries duty | 2,947 | 3,562 |
| Rubber estate assessment | 133 | 19 |
| Search & valuation fees | 146 | 185 |
| Rubber estate surcharge | 6 | 3 |
| Auctioneers, etc. | 5 | 5 |
| | 1,559,606 | 1,663,784 |

### (ii) Total inland revenue department's collection as percentage of gross Singapore revenue

| *Year* | *Total inland revenue.* | *Gross Singapore revenue* | *Ratio of inland Revenue to gross revenue* |
|---|---|---|---|
| 1975 | $1,559,606,419 | $3,055,093,905 | 51.05 |
| 1976 | $1,663,784,365 | $3,131,382,143 | 53.13 |

### (iii) Breakdown of customs revenue

| | *1975* $ | % | *1976* $ | % |
|---|---|---|---|---|
| Petroleum | 121,309,812.56 | 28.05 | 125,754,990.86 | 26.53 |
| Tobacco | 108,343,737.41 | 25.05 | 119,973,808.84 | 25.31 |
| Liquors | 102,985,675.73 | 23.81 | 107,597,722.48 | 22.70 |
| Others | 99,909,657.63 | 23.09 | 120,705,448.67 | 25.46 |
| | 432,548,883.33 | 100.00 | 474,031,970.85 | 100.00 |

## B. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH ESTATES & GIFTS

### (1) Investment (domestic & foreign)

Singapore pursues a policy of attracting and stimulating domestic and foreign investments both by tax and other incentives. To attain the desired objectives, provisions have been made in the various Acts to stimulate economic growth of industries and capital formation. The major incentives are as follows: —

| *Incentives provided under the Economic Incentives (Relief from Income Tax) Act* | *Practical effects* |
|---|---|
| - Exemption from Income Tax | - 5-15 years tax holidays for pioneer industries. |
| - Deductions from taxable base and tax deferment | - Relief for expansion of established enterprises.<br>Relief for export enterprises. |
| - Reduction in the tax rate | - Royalties, technical assistance fees or contributions taxed at a reduced rate of 20 percent or exempt from tax.<br>Interest on loans obtained for purchase of productive equipment may also be exempted. |

| | |
|---|---|
| *Incentives provided under the Singapore Income Tax Act (chapter 141)* | - Double deduction of expenses for manufacturing firms incurred on approved for overseas trade fairs, or exhibitions or missions for the purpose of promoting the export of goods manufactured in Singapore.<br>- Accelerated depreciation allowances of 33 1/3 percent for industrial enterprises.<br>- Exemption of profits from the operation of Singapore ships.<br>- Reduction of tax on off-shore income of a financial institution derived from the operation of its Asian Currency Unit from 40 to 10 percent. |

*Relief provided under double taxation agreements*

Agreements for the avoidance of double taxation have gained increasing importance because such agreements not only avoid double taxation on the same income, but also provide incentives for the flow of investments, trade, technology and skilled personnel. They help in industrialisation programmes and economic growth. Under these agreements, relief is provided either by exemption in one country or by the granting of a credit for the tax charged in the other country but not exceeding the tax charged on the same income in that country.

Currently, Singapore has double taxation agreements with Australia, Belgium, Canada, Denmark, France, Germany, Israel, Japan, Malaysia, Netherlands, Philippines, New Zealand, Norway, Sri Lanka, Sweden, Thailand and the United Kingdom.

*Other advantages*

(a) Political, economic and social stability and efficient government administration;
(b) Protection of patents and other proprietary rights;
(c) Permanent residence status for any investor who has invested more than $250,000 individually;
(d) Good industrial climate, social harmony and stability in labour relations;
(e) Free-trade zones in the harbour and airport areas;
(f) Efficient services and enviable human resources;
(g) Telecommunications centre of South East Asia;
(h) Liberal foreign exchange policy;
(i) Internationally competitive labour costs;
(j) Open door policy with regard to admission of professionals and skilled workers;
(k) Port facilities including container berths, Singapore being the world's fourth busiest port;
(l) Rapid development in internal road communications and transport services;
(m) Highly-developed infrastructure services with supporting banking and commercial facilities and other business services;
(n) Adequate and modern telephone services with connections throughout the world;
(o) International airport facilities and services;
(p) Strategic geographical location;
(q) Back-up services by Government departments and agencies;
(r) Extensive Government sponsored technical training programmes;
(s) Availability of local capital.

## (2) Trade (domestic & foreign)

Trade has always been the main activity of Singapore. Due to its geographical position, Singapore has remained an important centre for entrepot trade. The pattern of entrepot exports remained relatively unchanged since 1972.

The combined export promotional efforts of Government departments, Statutory Boards and trade associations help largely in obtaining new markets for exports. Various means which the Department of Trade and other Government departments or statutory bodies have adopted to increase the volume of trade are: —

(i) Improvement in the programme of the Department of Trade to service manufacturers in their exports;
(ii) Increase in participation in trade fairs and exhibitions in all parts of the world;
(iii) The formation of overseas Commercial Secretaries Service with emphasis on hard selling;
(iv) Undertakings by Government Departments and agencies and others to provide various assistance schemes;
(v) Re-location of trade offices and establishment of new ones.
(vi) The provision of a better trade information system and a more efficient enquiry service;
(vii) The organisation of training programmes by the Department of Trade;
(viii) The re-discounting facilities extended to the banks by the Government to ensure a cheaper source of export financing;
(ix) Organisation of buying missions to Singapore.

There has been an increase in investments in imported capital goods and this reflects the rapid industrial growth in the economy.

The three leading trading partners of Singapore are Japan, the United States and Malaysia. Other trading partners are Australia, China, Germany, United Kingdom and West Asia.

For international firms trading in the South East Asia region, Singapore is the natural distributing centre for machinery and capital goods. It is the island warehouse for the region.

## (3) Transfer of technology know-how and managerial skills

Singapore's economy is now more broadly based with expanded activities in manufacturing, trade, finance, construction, transportation and tourism. However, great emphasis is being applied to technology-intensive activities.

Incentives provided include concessionary tax rates for income derived from royalties, licences and fees paid to non-residents abroad and a concessionary tax rate on profits earned from the export of manufactured products.

The Singapore Government has also initiated a capital assistance scheme under which it is prepared to invest up to 50 percent of the equity in new ventures to help to meet the financing requirements of companies establishing technology-intensive operations for the manufacture of products having demonstrable markets. Financial loans and government guarantees for loans are given to high-technology industries with established markets and proven capabilities. Long-term loans at preferential rates of interest are also available from the Development Bank of Singapore (DBS). Recognising the importance of foreign investment in its programme of industrialisation, the Government permits 100 percent foreign ownership of manufacturing enterprises and has an enlightened policy governing the entry of qualified foreign personnel into Singapore.

To upgrade the quality of the work force and in particular the professional and skilled personnel for the technology-intensive industries, the Government adopts a liberal policy to allow the in-flow of suitable foreign personnel in the trading, shipping and manufacturing industries. Work permits or professional passes are granted to foreigners with professional or sound academic qualification, management expertise and experience, technical skill and knowledge. Permanent residence and later citizenship may be granted to certain categories of persons. There are four schemes for permanent residence: —

(a) Permanent residence for professionals, technical personnel and skilled workers;
(b) Permanent residence under the $250,000 Deposit Scheme;
(c) Permanent residence under the Industrial Export Scheme;
(d) Permanent residence and citizenship fo;skilled workers holding Work Permits.

**(4) Diversification and selectivity**

(a) *As to countries from which investment, technology, etc. is solicited*

Singapore welcomes investment, technology, etc. from any source so long as it meets the economic development objectives and is in line with Government policies. One of the objectives is to expand the industrial sector to complement traditional trading activity. As the industrialisation programme has been so successful the Government has become more discriminating in the types of industries to be established in Singapore. The Government now intends to focus on attracting the large capital or technology-intensive industries. These enterprises can maximise scarce resources and introduce significant technological development to Singapore so that Singapore manufactured goods for export can compete in international markets.

(b) *As to types or areas of investment, trade, etc.*

Various types of fiscal and other non-fiscal incentives are given to pioneer enterprises, to preferred areas of investments, etc. The approach to foreign technical and financial collaboration is both selective and flexible. The need for importing technology is based on domestic technological development.

The Singapore Government welcomes foreign trading companies engaged in the supply of raw materials to Singapore's industries or foreign export-oriented trading organisations capable of helping Singapore to export her products. International companies setting up regional or representative offices to perform liaison and promotion activities using Singapore as a centre for marketing and distributing operators are given all necessary assistance and incentives, both fiscal and non-fiscal by the Government.

(c) *As to regional or special areas, including free trade zones*

Emphasis is being laid on setting up industries in the various zones of the Republic earmarked for industrial development. To encourage increased trading activities, several free trade zones have been established at strategic points under the Free Trade Zones Act.

The waterfront area of the Port of Singapore Authority and the Jurong Wharves are free trade zones. As long as goods remain stored in the free trade zones, no duties need be paid.

There are a number of government departments and agencies which help investors to promote industrial development. These include the Economic Development Board (EDB), Development Bank of Singapore (DBS), Department of Trade, Jurong Trade Corporation (JTC), International Trading Corporation (INTRACO), Singapore Institute of Standards and Industrial Research (SISIR), Monetary Authority of Singapore (MAS) and National Productivity Board (NPB).

**(5) Difference in treatment, if any, between the public and private sectors**

There is no difference in the tax treatment of the incomes of public sector undertakings and private sector undertakings. However, certain industries of basic and strategic nature are reserved for the public sector only.

## C. ORIENTATION OF FISCAL POLICY: SALES TAXES, EXCISE DUTIES, CUSTOMS

(i) (Re-)distribution of wealth;
(ii) Employment;
(iii) Regional development.

The Government pursues a policy of wealth and income (re)distribution in order to spread more equitably the benefits of progress. The indirect tax system (excise duties, custom duties, specific taxes on certain commodities and services) is extensively used to meet this goal by means of higher taxes on commodities commonly consumed by the rich, on non-essential or luxury goods etc. The income tax on individuals is based on graduated rates i.e. the higher the income, the higher the marginal tax rate.

There is a fund called the Central Provident Fund set up and managed by the Government. This fund is one of several instruments used to achieve social stability. Contributions by employers and employees are compulsory as this is a compulsory savings scheme. It provides workers with some security for their old age and a means of buying their own homes from the Housing & Development Board. There is a tremendous increase in savings due to the rapid growth in employment in recent years. The Central Provident Fund contributions serve a number of other useful purposes. First, they reduce the pressure on prices which might otherwise increase faster as a result of more employment and increased pay. Second, they provide the Government with a non-inflationary source of funds for development finance.

With the establishment of the C.P.F., the number of families receiving Public Assistance from the Social Welfare Department has been on the decline. There is now less proverty and this is attributed to the Government policy of encouraging self-reliance and hard work.

The reason for Singapore emarking on a policy of industrialisation was to prvide work for a large number of young persons entering the labour market each year. In recent years, since unemployment is no longer the problem, it is now the Government's policy to be more discriminating in the kind of industries it actively encourages through incentives. The industries that are encouraged are those requiring the use of trained and skilled workers. These industries can enjoy free access to any grade of labour from any part of the world they wish. Work Permits and professional visit passes are freely granted to them.

The Government has developed several satellite towns and many well-developed industrial estates providing cheap labour in Singapore. Where necessary, it creates, supports and strengthens institutions and provides incentives to carry out the development of these various areas.

The Government also encourages Singapore industrialists and entrepreneurs to invest in the neighbouring Asean countries to promote regional economic development. Capital and expertise from Singapore can help the Asean countries to develop their natural resources and provide industrial employment opportunities. Singapore companies are granted tax exemptions on profits derived from investments in approved projects in Indonesia. For Singapore investments in Malaysia, there is double taxation relief on profits received in Singapore from Malaysia.

## D. ORIENTATION OF FISCAL POLICY: OTHER (NON-TAX) FIELDS

(i) Subsidies;
(ii) Special low interest loans;
(iii) Providing infrastructure in particular areas (e.g. industrial estates);
(iv) Others (e.g. the creation of free trade zones and allied facilities).

Some fiscal and non-fiscal incentives are set out in section B. Subsidies may be in the form of reduction in rent for housing or low-rental housing for employees in the industrial estates. The Housing & Development Board (HDB) has a very successful housing programme. It has helped to eliminate most of the slum and squatter areas. Nearly half the population of Singapore lives in subsidised flats built by the HDB.

Approved industries may be able to obtain special low interest loans for capital investment either through the assistance of the EDB or the Development Bank of Singapore Ltd.

A scheme known as the Small Industries Finance Scheme (SIFS) was launched in 1976 to upgrade small industries. It has since been expanded in scope to allow more companies to benefit from it. It is operated jointly by the EDB and teh Development Bank of Singapore. To qualitfy for loans under this scheme a company must have fixed assets not exceeding $1 million ($2 million in special cases) and it must be involved in manufacturing and assembly operations or supporting services related to manufacturing. The loans obtained must be for the purpose of establishment of new viable business, expansion of existing capability, modernisation, diversification and augmenting working capital.

As regards infrastructure, the Government strives to make it easy and attractive for manufacturers to set up business in Singapore. A large industrial estate was built in Jurong with its own port to handle bulk cargo, equipped with rail and road transportation as well as adequate supplies of power and industrial water.

One of the most important factors in the economic development of Singapore has been the high degree of development in its logistical and financial infrastructure. Laws and regulations governing financial activities were modified to make these more conducive to the growth of financial institutions and the development of financial mechanisms. This has been done in the context of facilitating the requisite financial support for trade and manufacturing and for further diversifying the Singapore economy.

The result is that Singapore has a well-developed stock market, has the most progressive and sophisticated financial mechanisms in the region and a firm place in the international financial system. This has also led to an accelerated growth of the banking system and the Asian Currency Market.

The Export Credit Insurance Corporation, jointly owned by the Government and the private sector performs an important role in the promotion of export industries. It grants insurance coverage against non-payment caused by political and commercial factors to an exporter who sells on credit.

## E. EVALUATION

### (a) Government policies and goals

It has always been the Government's economic development policy: —

(i) to maintain Singapore as a trading centre;
(ii) to stimulate the development of industries;
(iii) to continue to attract foreign investments; and
(v) to promote Singapore as a financial centre.

Since the separation of Singapore from Malaysia it has, throughout these years, achieved its basic objectives and is now placing greater emphasis on higher technology and capital intensive industries. The activities have now been expanded in manufacturing, trade, finance, construction, transportation and tourism.

The Singapore economy is a growing economy. It has a strong currency. The Singapore dollar is fully backed by gold and foreign assets and rated by the International Monetary Fund as one of the strongest currencies in the world.

Singapore has thrived as an international business centre for many years and its economy has been adapted to changing circumstances. From an entrepot trading centre it has become an important centre for manufacturing, commerce, finance and communications. The diversification of the Singapore economy is the result of the introduction of the Industrialisation Programmes initiated in the 1960's.

Singapore has overcome the handicaps of size, small population and lack of natural resources. Foreign investors have brought to Singapore technological and managerial skills, new export markets and capital investments. Multi-national corporations have contributed to Singapore's rapid economic growth.

Today Singapore is the world's third largest oil refining centre, the world's fourth busiest port, an important key link in international air routes and telecommunications, a leading shipbuilding and repairing centre, and also the important financial centre for the Asian Dollar Market.

## (b) Performance in 1977

Although world economic growth slowed down in 1977, Singapore managed to achieve a real economic growth rate of 7.8 percent. Higher demand for Singapore's goods and services provided the main thrust for growth. Exports of goods and services increased by 14 percent compared to 11 percent in 1976. All sectors of the economy expanded except for construction and quarrying.

Growth was led primarily by commerce and transportation. The commercial sector covering wholesale and retail trade and restaurants and hotels, grew by 10 percent while communications and transport expanded by 16 percent.

Manufacturing expanded at a more steady pace. Unemployment fell to 3.9 percent. The commercial and manufacturing sectors created most of the 33,500 new jobs.

The construction industry, however, declined by 1.6 percent because of continued depression in the private property market and the levelling off in public sector development spending.

In external trade, total imports in 1977 rose by 14 percent to reach 25.5 billion and total exports by 24 percent (domestic exports by 25 percent) to reach $20.1 billion. Industrialisation had brought about a distinctive change in the composition of exports.

Gross National Product (GNP) at current market prices amounted to $15.7 billion, an increase of 10 percent over 1976.

Gross Domestic Product (GDP) which does not take into account net income from abroad, at current market prices increased by 10 percent to $16.1 billion.

Gross Domestic Product (GDP) at current factor cost, which excludes indirect taxes, also increased by 10 percent to $15 billion. Growth was achieved with relative price stability.

Adjusting for inflation, GDP at constant 1968 factor cost grew by 7.8 percent to $9.3 billion, while real per capita GDP rose by 64 percent to $4,020.

Below are some interesting figures extracted from the Economic Survey of Singapore 1977 published by the Ministry of Finance, Republic of Singapore:

| | | |
|---|---|---|
| Table I | – | Output And Saving, 1975–1977. |
| Table II | – | Gross Domestic Fixed Capital Formation At Current Market Prices, 1975–1977. |
| Table III | – | Singapore External Trade, 1973-1977. |
| Table IV | – | Per Capita Gross National Product, 1960 And 1968–1977. |
| Table V | – | Employment, Output, Value Added And Remuneration. |
| Table VI | – | Investment Commitments In Manufacturing By Industry 1973–1977. |
| Table VII | – | Foreign Investment – Gross Fixed Assets Of Manufacturing Industries By Foreign Country. |

### I. OUTPUT AND SAVING, 1975–1977

| | 1975 | 1976 | 1977p | 1975 | 1976 | 1977p |
|---|---|---|---|---|---|---|
| | Million Dollars | | | Percentage Change | | |
| Gross National Product at Market Prices | 13,216 | 14,286 | 15,669 | 9 | 8 | 10 |
| Gross Domestic Product at Market Prices | 13,373 | 14,615 | 16,091 | 7 | 9 | 10 |
| Gross National Saving | 3,602 | 3,747 | 4,073 | 25 | 4 | 9 |
| Gross Domestic Saving | 3,851 | 4,197 | 4,615 | 13 | 9 | 10 |
| Net Borrowing from Abroad | 1,433 | 1,745 | 1,360 | -47 | 22 | -22 |

*Source:* Department of Statistics

### II. GROSS DOMESTIC FIXED CAPITAL FORMATION AT CURRENT MARKET PRICES, 1975–1977

~~Percent~~

| | 1975 | | | 1976 | | | 1977p | | |
|---|---|---|---|---|---|---|---|---|---|
| Type of Assets | Total | Public | Private | Total | Public | Private | Total | Public | Private |
| TOTAL | 100 | 28 | 72 | 100 | 33 | 67 | 100 | 33 | 67 |
| Construction and Works | 45 | 23 | 22 | 46 | 27 | 19 | 44 | 26 | 18 |
| Transport Equipment | 16 | – | 16 | 20 | – | 20 | 23 | – | 23 |
| Machinery and Equipment | 39 | 5 | 34 | 34 | 6 | 28 | 33 | 7 | 26 |

*Source:* Department of Statistics

## III. SINGAPORE EXTERNAL TRADE, 1973–1977

| Year | Total Trade | Imports | Exports | Total Trade | Imports | Exports |
|---|---|---|---|---|---|---|
| | Million Dollars | | | Percentage Change Over Previous Year | | |
| 1973 | 21,420 | 12,513 | 8,907 | 37 | 31 | 45 |
| 1974 | 34,560 | 20,405 | 14,155 | 61 | 61 | 59 |
| 1975 | 32,028 | 19,270 | 12,758 | -7 | -6 | -10 |
| 1976 | 38,670 | 22,404 | 16,266 | 21 | 16 | 27 |
| 1977p | 45,612 | 25,522 | 20,090 | 18 | 14 | 24 |

*Source:* Department of Statistics

## IV. PER CAPITA GROSS NATIONAL PRODUCT, 1960 AND 1968–1977

| Year | Per Capital Gross National Product * |
|---|---|
| | Dollars |
| 1960 | 1,330 |
| 1968 | 2,188 |
| 1969 | 2,499 |
| 1970 | 2,825 |
| 1971 | 3,228 |
| 1972 | 3,765 |
| 1973 | 4,502 |
| 1974 | 5,457 |
| 1975 | 5,874 |
| 1976 | 6,271 |
| 1977p | 6,789 |

*Source:* Department of Statistics

* At Current Market Prices.

## V. EMPLOYMENT, OUTPUT, VALUE ADDED AND REMUNERATION

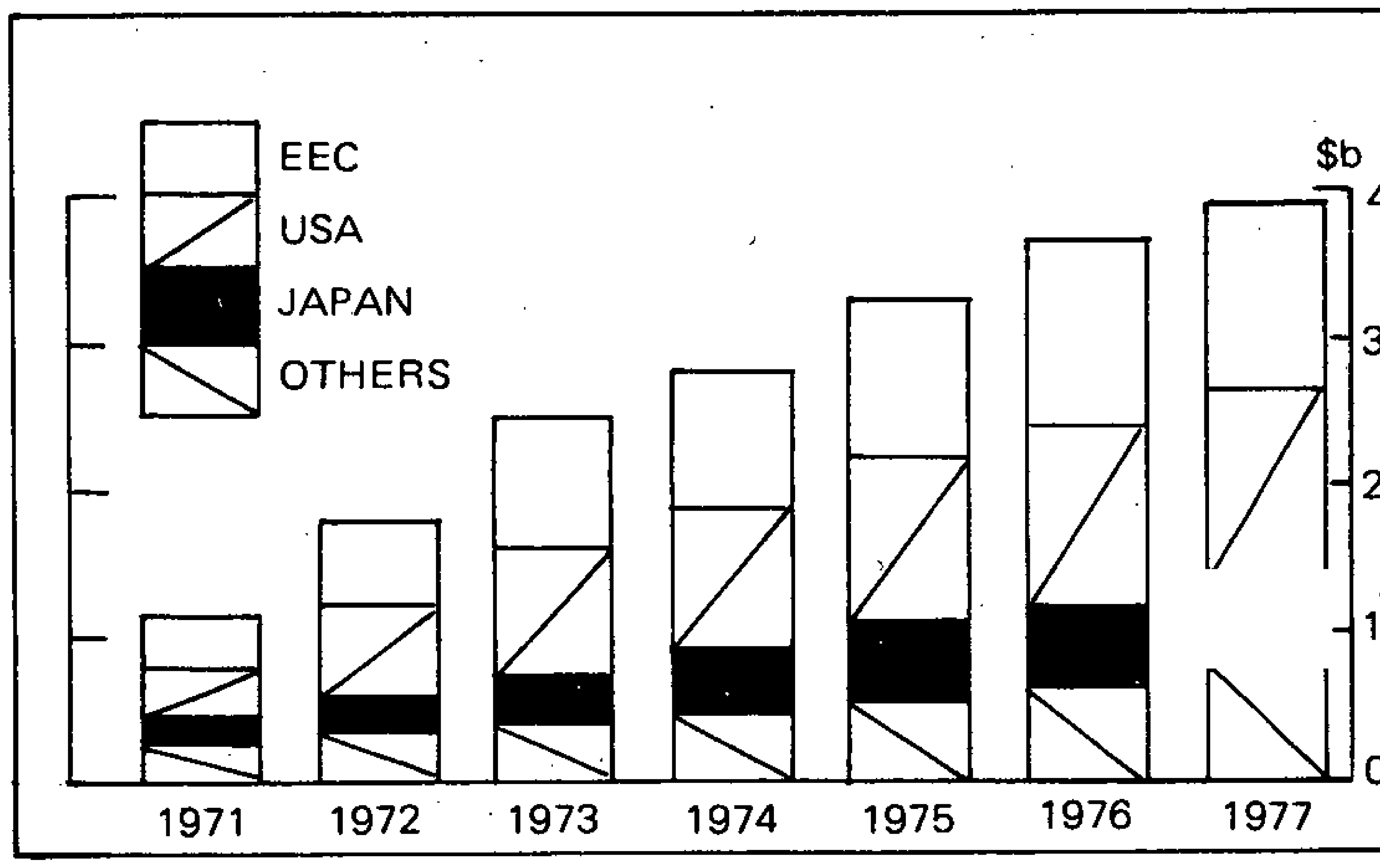
| | Employment % | Output % | Value added % | Remuneration % |
|---|---|---|---|---|
| Food, beverage, tobacco | 6.0 | 7.8 | 6.1 | 6.3 |
| Textiles | 5.1 | 2.0 | 2.7 | 3.8 |
| Apparel | 11.0 | 2.6 | 3.5 | 6.0 |
| Wood (excl. furniture) | 4.4 | 2.5 | 3.2 | 3.8 |
| Furniture | 1.5 | 0.4 | 0.6 | 1.2 |
| Paper & Printing | 6.2 | 2.6 | 4.8 | 6.0 |
| Chemicals | 2.4 | 3.3 | 5.3 | 3.4 |
| Petroleum | 1.6 | 42.7 | 17.9 | 5.7 |
| Rubber, plastic, prod. | 3.6 | 1.5 | 1.9 | 2.7 |
| Non-metallic minerals | 2.3 | 2.1 | 3.1 | 2.8 |
| Basic metals | 0.7 | 0.9 | 1.3 | 1.1 |
| Fabricated metal prod. | 5.8 | 3.0 | 4.1 | 5.9 |
| Machinery, appliances | 30.8 | 18.9 | 27.9 | 28.5 |
| Transport equipment | 12.8 | 7.4 | 13.6 | 18.3 |
| Precision equipment | 3.6 | 1.2 | 2.8 | 3.0 |
| Misc | 2.2 | 1.1 | 1.2 | 1.5 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 |
| | (217,548) | ($17.64b) | ($4.38b) | ($1.42b) |

## VI. INVESTMENT COMMITMENTS IN MANUFACTURING BY INDUSTRY 1973–1977

| | ($m) | | | | |
|---|---|---|---|---|---|
| Industry | 1973 | 1974 | 1975 | 1976 | 1977 |
| Electric Machinery & Appliances | 43.2 | 42.1 | 14.1 | 165.2 | 127.0 |
| Petroleum Products | 250.0 | – | 135.0 | 16.0 | 66.2 |
| Transport Equipment | 168.0 | 108.0 | 42.0 | 5.7 | 36.1 |
| Food & Beverages | 2.0 | – | 2.7 | 14.4 | 27.7 |
| Other Chemical Products | 2.4 | 15.0 | 2.0 | 0.4 | 21.4 |
| Plastic Products | 9.3 | – | 4.3 | 12.5 | 10.8 |
| Others | 469.2 | 653.7 | 200.3 | 150.0 | 141.8 |
| Total | 944.1 | 821.8 | 400.4 | 364.2 | 431.0 |
| Foreign | 683.5 | 681.6 | 267.3 | 294.7 | 390.5 |
| Local | 260.6 | 140.2 | 133.1 | 69.5 | 40.5 |

## VII. FOREIGN INVESTMENT

**Gross fixed assets of manufacturing industries by foreign country**




## LIST OF TAX TREATIES

**Concerning comprehensive double taxation treaties on income/capital**

**This list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Australia | income | February 11, 1969 | English | AP treaties<br>SLS 10/69<br>Treaty Series, Vol. 708, p. 228 |
| Belgium | income | February 8, 1972 | English | AP treaties<br>SUPP. SER. Section C<br>SLS 53/73 |
| Canada | income | March 6, 1976 | English and French | AP treaties<br>SLS 45/1977 |
| Denmark | income | March 7, 1969 | English | AP treaties<br>SUPP. SER. Section C<br>SLS 16/69<br>Treaty Series, Vol. 751, p. 202<br>IX UN A(1) 270 |
| France | income | September 9, 1974 | English and French | AP treaties<br>SUPP. SER. Section C<br>SLS 39/75 |
| German Federal Republic | income, capital | February 19, 1972 | English and German | AP treaties<br>SUPP. SER. Section C<br>SLS 51/73<br>IX UN A(1) 315, 335 |
| Israel | income | September 27, 1971 | English | AP treaties<br>SLS 26/72<br>IX UN A(1) 334<br>BULL Supplement C (1974) |
| Japan | income | January 29, 1971 | English | AP treaties<br>SLS 49/71<br>IX UN A(1) 283 |
| Malaysia | income | December 26, 1968 | English | AP treaties, as amended<br>SLS 97/68 |
| Supplementary agreement | income | July 6, 1973 | English | SLS 40/73 |

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Netherlands | income, capital | February 19, 1971 | English and Dutch | AP treaties<br>SUPP. SER. Section C<br>SLS 57/71<br>IX UN A(1) 297, 330<br>Treaty Series, Vol. 801, p. 29 |
| New Zealand | income | August 21, 1973 | English | AP treaties<br>SLS 65/73 |
| Norway | income | September 9, 1966 | English | AP treaties<br>SUPP. SER. Section C<br>SLS 67/66<br>IX UN A(1) 170 |
| Philippines | income | August 1, 1977 | English | AP treaties<br>SLS 53/77 |
| Sweden | income, capital | June 17, 1968 | English | AP treaties<br>SUPP. SER. Section C<br>SLS 11/69 |
| Switzerland | income, capital | November 25, 1975 | English and German | AP treaties<br>SLS 57/76<br>IX UN A(1) 366 |
| Thailand | income | September 15, 1975 | English | AP treaties<br>SLS 20/76<br>BULL Supplement I (1976)<br>IX UN A(1) 364 |
| United Kingdom | income | December 1, 1966 | English | AP treaties, as amended<br>SUPP. SER. Section C, as amended<br>SLS 12/67<br>IX UN A(1) 176<br>Treaty Series, Vol. 605, p. 154 |
| Protocol * | income | July 1921, 1975 | English | SUPP. SER. Section C<br>IX UN A(1) 354 |

* Not yet in force.

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties.
BULL = Bulletin for International Fiscal Documentation.
SUPP. SER. Section C = Supplementary Service to European Taxation, Section C.
SLS = Subsidiary Legislation Supplement. The Republic of Singapore Government Gazette.
Treaty Series = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French as the case may be.
UN = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and French edition. This publication contains several volumes.

# AUSTRALIA: Second Reading Speech

## (Income Tax Assessment Amendment Bill (No. 2) 1978

### by The Treasurer, the Hon. John Howard, M.P. (June 8, 1978)

The bill that I now bring before the House contains further measures to counter tax avoidance and to improve the equity and balance of the income tax system. It also contains legislation designed to encourage investors to put capital into the production of Australian films.

Honourable Members will recall that just two months ago I introduced a number of major amendments directed against prevailing tax avoidance practices. I spoke then in a general way about the problems that are posed by tax avoidance arrangements, and I have since had occasion to put the Government's position on the matter and to underline the seriousness of our intent to strike these arrangements down.

I shall, however, speak first about the policy initiative concerning capital investment in Australian films.

#### Capital investment in Australian film rights

The proposal to change the Income Tax Law in this respect was foreshadowed in the policy speech for the last elections delivered on 21 November 1977, and the key points of the changes were outlined in a statement that the Minister for Home Affairs and I released on 27 April last.

Underlying the proposed changes is a belief that if investors could deduct their capital investment in Australian film rights over 2 years instead of, as at present, over a much longer period of up to 25 years, there would be greater investment by Australians in the production of Australian films. There are obvious tax benefits in a quick write-off of capital costs and, when this new concession is taken together with other assistance such as that provided through the Australian Film Commission, the Government can justly claim to be lending significant support to the Australian film industry and all engaged in it.

The concession for capital investment in Australian film rights will be implemented by amendments to the provisions of the Income Tax Law that have, since 1956, allowed otherwise non-deductible capital costs of acquiring industrial property rights used in the production of assessable income to be written off over specified periods. For copyrights, which are the relevant property in this context, the costs have been subject to a tax write-off over 25 years, or any lesser period for which the rights subsist or are held. The amendments now proposed will - in relation to rights in Australian films first used for income producing purposes after 21 November 1977 - substitute 2 years for 25 years as the basic write-off period. The longer period will, however, remain for those who wish to use it.

The Minister for Home Affairs will have the responsibility of determining which films are to be classed as "Australian films". The Bill proposes that an Australian film will be one that the Minister certifies has been, or is to be, made wholly or sustantially in Australia, and is a film with a significant Australian content. It will also include a film that the Minister certifies has been, or is to be, made under an agreement between Government authorities of Australia and another country. The Bill contains extensive guidelines for the determination of when a film has a significant Australian content.

In amending the relevant provisions, it is necessary also to guard against their misuse for tax avoidance purposes, and the Bill contains measures to that end, effective after 27 April 1978, the date on which the amendments were foreshadowed. The anti-avoidance measures are directed against arrangements to secure excessive deductions by inflating the cost of rights or by deflating their sale price when they are disposed of.

#### Current year losses

In terms of space - 43 of its 68 pages - the present Bill is mainly devoted to amendments dealing with current year losses that I announced in this House on 7 April when introducing the Income Tax Assessment Amendment Bill 1978, And that are now expressed to be effective as from that date.

Honourable Members will recall from my earlier speech that these amendments are to employ and adapt the well-settled principles governing the deductibility by companies of losses sustained in prior years. In the relatively uncomplicated case, the adapation will mean that, where there is a point within a year of income at which there has been a more than 50 percent change in beneficial owership of the company as at the beginning of the year, the net losses sustained by the company in the period before the change will not be available to be offset against the net income of the period after the disqualifying change, unless the company has carried on throughout that income period the same business as it carried on immediately before the change. Similar principles are to apply where an income period of a year precedes a loss period of the same year.

The point of these amendments, as of the provisions governing deductibility of prior year losses, is to prevent income earned by a company under the proprietorship of one set of shareholders being diminished for tax purposes by losses sustained under the proprietorship of a different group of people.

The proposed amendments are undoubtedly complex. This is due to the effort that has been made to spell out, in the great variety of factual situations that can exist in practice, how the current year losses provisions are to operate, and to guard against the new provisions being themselves made the subject of tax avoidance arrangements.

Much of what is in the measures stems from the necessity to modify provisions of the assessment act that are constructed for application to a year of income as a whole so that they can be applied to separate periods that make up a year.

Moreover, the measures must be capable of effecting this modification where a company that has suffered a disqualifying change in shareholdings gets its income or deductions via a partnership or its income through a trust. And, of course, the legislation has to comprehend situations where there is more than one disqualifying change in shareholdings in the course of a year, and a mixture of loss and income periods.

#### Dividend stripping

Here too, I refer Honourable Members to what I have said on earlier occasions - in this instance in my second reading speech on 7 April last and in a subsequent statement that I released on 7 May.

The proposed amendment under this head is yet another legislative attempt to prevent companies that engage in dividend stripping from achieving double benefits.

The double benefit, where it arises, is represented by the freedom from tax of the stripping dividend conferred by the rebate on inter-corporate dividends plus a deduction for the loss on the sale of the stripped shares after their value has been reduced by payment of the dividend.

A provision was enacted in 1972 with the purpose of eliminating this double benefit.

It specifies that only so much of a dividend received in a straightforward dividend stripping operation as exceeds the cost to the stripping company of the shares to be stripped may qualify for rebate. That provision is now being amended, effective from 7 May 1978, to make it applicable where a third company, or a trust, is interposed between the company to be stripped and the stripper. The cost of the shares or interests in the interposed company or trust will be offset against the amount of stripping dividend otherwise eligible for rebate.

Also effective from 7 May 1978 will be an amendment to the new anti-stripping provisions being introudced by the Bill brought down in April. These new provisions strike at practices whereby a company receives the stripping dividend but an associated entity suffers the paper "loss" on the purchase and sale of the shares to be stripped. While they guard against a company being interposed between the company to be stripped and the stripper, they do not cater for similar interposition of trusts. That gap is now being closed.

### Branch profits tax

The Government also proposes by this Bill to give form to the proposed branch profits tax on the taxable income of non-resident companies that was foreshadowed in a statement to the House by the Minister assisting the Treasurer on 4 November 1977.

As indicated then, there is a lack of balance in our tax system as between foreign companies that carry on business in Australia through a subsidiary company incorporated or otherwise resident here, and those that conduct their business through a branch of a company resident, for tax purposes, in another country.

In each case, taxable income is computed in the same way and bears the same rate of company tax - now 46 percent - but while the profit remittances of the subsidiary bear dividend withholding tax, there is no further tax in respect of "remittances" of branch profits to head office or of dividends paid to foreign shareholders out of those remittances.

The additional tax proposed to be levied on taxable income of non-resident companies is being introduced to redress this lack of balance. It will be at the rate of 5 percent of the taxable income of the branch. The tax is being levied in this form because it is impracticable to impose a tax on "remittances" of branch profits.

In striking a branch profits tax rate of 5 percent of taxable income, the Government has aimed to achieve, as closely as is practicable, a reasonable balance in the Australian tax liabilities attaching to profits of foreign-owned subsidiaries and branches, bearing in mind that, in both cases, the companies are likely to plough back some of their profits into further developments in Australia.

In last year's announcement of the branch profits tax, it was indicated that the tax would not fall on dividend income of branches, nor would it apply to film royalties, shipping profits or insurance premiums taxed under special provisions. These exclusions are made by the Bill.

Representations made to the Government since the time of that announcement have led to one additional exclusion. This concerns the profits of non-resident life assurance companies that are allocated towards bounuses and other payments due to Australian policy holders. The Government has accepted the point that, if the tax were placed on these profits, it would effectively be borne by Australian policy holders and not, as intended, by the company or its overseas shareholders, if any.

The Government has decided that the tax will apply to that part of the 1977-78 tax year falling after 4 November 1977, and to subsequent years.

Although the branch profits tax takes the form of a rate increase, it is in essence a new tax. Hence it would be inappropriate to make it retrospective in effect by applying it to the full 1977-78 tax year.

Befor concluding my remarks on this subject, I mention that while the basic application of the branch profits tax is provided for in this bill, the Income Tax (Non-Resident Companies) Bill 1978 that I shall shortly introduce will formally declare the rate of the tax.

### Private companies in liquidation

I come now to measures designed to meet representations from the liquidators of private companies that the undistributed profits tax provisions of the income tax law are so structured as to cause unreasonable delay in the final winding up of private companies in liquidation.

An example may be the best way of illustrating the point. Let us say that a private company has earned a taxable income in the first 4 months of an income year and its liquidator wishes to make an immediate distribution of the income to shareholders, and to wind the company up. The problem is that he must wait 6 months until May of the income year to effect the distribution because only the dividends paid in the prescribed period of 12 months commencing 2 months before the end of the income year can be taken into account for undistributed profits tax purposes in relation to the year.

To overcome the difficulty, liquidators in this situation will be enabled by the Bill to make a qualifying distribution to shareholders before the commencement of the prescribed period.

Mr. Speaker, that completes my remarks at this stage on the main features of the present Bill. All of its provisions will, as usual, be explained in a comprehensive explanatory memorandum. It has not, however, been practicable to complete the memorandum in time for introduction of the Bill. It will be made available to Honourable Members shortly.

I mention at this point that the Government will not be seeking passage of this Bill until the Budget sittings. Given the complexity of much of it I think that there should be ample opportunity for interested people to examine it and comment on its technical features. These will, in any event, be subject to review by officials during the recess.

The Government plans to bring still further income tax amendments before the Parliament early in the Budget sittings. It seems appropriate that Honourable Members and others who wish to study the present Bill during the recess should also have notice of other proposals that the government will later be asking the Parliament to adopt. In addition to the measures I now proceed to outline, these later changes will include the legislation against avoidance through prepaid interest, pre-paid rent and similar schemes that I spoke of in a statement on 19 April 1978.

### Foreign tax credit system

Mr. Speaker, the point has been made that recent tax measures by the Government are hasty improvisations and that the Government ought to be bringing forward remedial legislation of a more general kind. This is an option open to the Government and one that will, as evidenced by the significant changes I now outline, be exercised.

These changes concern the income that Australian residents - people and companies - derive from sources in another country. Shortly stated, it is proposed to tax this income, subject to credit for the foreign tax that has been paid on it.

When the Commonwealth income tax was introduced, it was on the basis that Australian residents were taxable only on income from within Australia. Over the years, there has been a movement to make foreign-source income of Australians taxable, but it remains the fundamental position that Australian residents are not taxed on significant categories of overseas income.

The position is in fact a hotchpotch. As a result of amendments made in 1941 and 1947, Australian resident individuals are taxed here on dividends from overseas, credit being allowed against the Australian tax for any foreign tax imposed on the dividends. But, because the rebate on inter-corporate dividends applies to dividends from overseas as well as to dividends from within Australia, foreign dividends received by Australian companies are tax-free in Australia, and this is so even if both the dividends and the profits out of which they are paid are not taxed in the overseas country of source.

Another rule introduced in 1967, applies to interest and royalties from another country on which foreign tax is limited by a double taxation agreement. These are taxable in Australia, subject to credit for the foreign tax. The credit system of relief applies also to income (other than salaries and wages) from Papua New Guinea.

All other foreign source income of Australian residents is exempt from Australian tax if it is subject to tax, no matter how negligible, in the country from which it is derived.

The Government considers that such outdated, and inconsistent, rules cannot be retained. The fact that major elements of the foreign-source income of Australians are not taxable in Australia seriously prejudices the equity of the tax system. Two Australians with the same total income can pay markedly different amounts of tax because one gets income from Australia and the other from overseas. There may even be an incentive for the diversion of economic activity away from Australia to places where the level of tax is lower than it is in Australia.

Most significantly, the present rules lend themselves to tax avoidance through the diversion of income to low-tax or no-tax countries.

The Asprey Committee has recommended that Australia introduce a credit system of taxing foreign-source income of Australian residents, and this lines up with the practice of most major developed countries.

Accordingly, with effect from the beginning of years of income or substituted accounting periods commencing on or after 1 July 1978 the basic rule will be that all foreign-source income of Australian resident people and companies will be taxable in Australia. However, the Australian tax on that income will be reduced by credit for foreign tax according to rules that I shall later outline.

Many Australians travel and work overseas for relatively short periods. As often as not, the level of the foreign tax is about the same as the Australian tax, before credit, that would be payable on the income if it were taxed here. Whether or not that is so, the Government feels that it would impose unnecessary complexity and difficulty on ordinary salary and wage earners to require that their foreign salaries and wages be dealt with under the credit system. At the same time, it is necessary to guard against avoidance practices that would remain if the existing exemption for foreign-source salaries and wages were to be fully retained.

Accordingly, it is proposed that foreign-source salary and wages which are taxed in the country of source will continue to be exempted up to a maximum of $10,000 per annum. Amounts in excess of this will be subject to Australian tax, with credit being available for the foreign tax paid on the excess. The exempted amount will be taken into account for the purpose of determining the rate of tax applicable to the taxpayer's assessable income.

To return to main features of the proposed credit system, a credit will be allowed for a tax imposed at one or another government level in the country in which the income is derived if the tax is one comparable with the Australian income tax. The foreign tax must have been paid and must, ordinarily, be a tax for which the taxpayer was personally liable. Credit will, however, be allowed for tax paid on a person's income by another person, such as an agent or trustee.

As is the case under credit systems generally, the credit for foreign tax paid in respect of a year will be limited to the Australian tax on the foreign-source income of the year, and for this purpose the Government proposes to adop the most generous of available methods by calculating the limitation on the basis of the aggregate foreign-source income of the taxpayer.

Dividends received from abroad by Australian companies deserve a special word. The basic rule will be that once such dividends are made effectively taxable by withdrawal from them of the rebate on inter-corporate dividends, a credit will be allowed for any foreign dividend withholding or other tax paid on them.

In addition, a credit for the "underlying" company tax on the profits out of which the dividends are paid will, on what is known as a "gross-up" basis, be allowed to Australian companies that have a more than portfolio investment in a foreign company. This credit will provide a direct recognition of the payment of any foreign company tax on those profits and will, at base, be allowed where the Australian company has a direct 10 percent or greater shareholding in the foreign company.

The credit for "underlying" tax will be extended beyond the underlying tax paid by the foreign company in which the Australian company has a direct 10 percent or greater interest to include such tax paid by a foreign company one further stage removed, if the Australian company has, through the first tier company, at least a 10 percent shareholding interest in the further company.

To guard against avoidance, the relevant 10 percent or greater shareholding must have been held for at least 12 months prior to the date of declaration of the dividend for a credit for underlying tax in respect of that dividend to be allowed.

There will, of course, be a number of more technical features of the credit system and, unfortunately, there will be both a need for further safeguards against avoidance as well as a degree of complexity in the legislation necessary to implement it. The Government does not shrink from that, having regard to the greater good that will come from the system's contribution towards tax equity and the reduction in avenues for avoidance. We are announcing our proposals at this stage so that taxpayers concerned will have an opportunity to plan for the pending introduction of the credit system.

**Foreign source income of trusts for Australians**

I refer now to another structural change that has as its principal purpose the prevention of tax avoidance by the use of trusts through which to derive foreign-source income. As the law stands, Australian residents can defer, or even escape altogether, the payment of tax on foreign-source income of trusts accumulated for their benefit.

The present situation, which the Asprey Committee has described as "unacceptable", results from a High Court decision some years ago to the effect that the trust provisions of the Income Tax Law have application only to Australian-source income of trusts. Until recently, the decision had not given concern. However, because of the tax avoidance possibilities and the plain interest of tax advisers in avoidance through international activities, the Government has decided that corrective measures must now be taken.

The scheme of the amending legislation is to be very close to that recommended by the Asprey Committee. Under it, the existing trust provisions will be extended to the foreign-source income of trusts that qualify as "Australian resident" trusts and also to the share of foreign-source income of non-resident trusts to which an Australian resident beneficiary is presently entitled. The effect of the rules relating to resident trusts will be that, generally, the world income of such trusts, like the world income of resident individuals, will be liable to tax in Australia, either in the hands of the beneficiaries or the trustee. Income will be treated as taxable under the trust provisions to the beneficiaries or the trustee according to whether, under the trust deed or for other reasons, beneficiaries are presently entitled to the income.

A resident trust is to be one of which at least one trustee is a resident, or which is managed and controlled in Australia.

Income flowing to a resident beneficiary from accumulated foreign-source trust income not taxed in Australia while accumulating, e.g., such income derived by a foreign trust, will be taxed in the hands of beneficiaries when recieved by them. Appropriate anti-avoidance rules will prevent beneficiaries escaping tax on a technicality that the amount or benefit is not received as income.

In keeping with the basic principle of taxing non-residents only on Australian-source income, a non-resident beneficiary presently entitled to foreign-source income of a resident trust will not be taxed on it. In addition, provision will be made to refund the appropriate amount of Australian tax paid on accumulated foreign-source income of a resident trust which is ultimately distributed to a beneficiary who is beneficially entitled to it and who, when the income was derived by the trust, was not a resident of Australia.

Appropriate credit will be given under the new foreign tax credit system for foreign tax paid on foreign-source income which is taxed in Australia to a trustee or beneficiary.

As an aid to administration, a trust carrying on business in Australia, or deriving income here from property, and which does not have a resident trustee, is to be required to have a public officer in Australia responsible for ensuring observance of the trust's taxation obligations, in the same way as a company.

I add that the partnership provisions of the Income Tax Law are to be amended so as to remove any possible doubt - arising from the Court decision I have referred to - as to their application to partnership income from sources out of Australia.

These amendments to the trust and partnership provisions of the Income Tax Law will apply to the 1978-79 and subsequent years of income.

Mr. Speaker, I commend the present Bill - and the Government's plans for future tax reform of a most important kind - to the House.

## AVOIDANCE OF INCOME TAX THROUGH PRE-PAID INTEREST, PRE-PAID RENT AND SIMILAR SCHEMES

The tax avoidance schemes referred to in Mr. Howard's Second Reading Speech were the subject of an announcement made on April 19, 1978. *

Mr. Howard said evidence had recently emerged that these schemes were being heavily promoted to clients who would not now be able to take advantage of artificially created losses under "Curran" and other schemes.

Large amounts of tax are involved.

The Commissioner of Taxation will be taking all administrative steps available to contest the deduction claims but the Government felt, Mr. Howard said, that remedial legislation should be brought before Parliament at the earliest opportunity.

Pre-paid interest, rent and other similar schemes come in various forms. Under one pre-paid interest scheme a taxpayer pays, in respect of each $1,000 borrowed for income producing purposes, an amount of pre-paid interest of $700. The amount is paid within 24 hours of the loan having been raised. It represents a pre-payment of interest for five years, at an annual rate of 14 percent. There is provision under the arrangements for the borrower or an associate to buy-back the loan from the lender after the interest has been paid. Because of the interest pre-payment and because the interest rate after five years' pre-payment is reduced to 4 percent, the loan of $1,000 has a reduced value, and it can be bought for $370. On this being done the taxpayer, together with his associate, will have outlaid $1,070 but, when the initial loan of $1,000 is taken into account, the net outlay is only $70. However, the taxpayer claims a deduction for the interest payment of $700.

On the other side of the coin, the lender — who has received $700 in interest income — would seek, as a money lender, to offset against that interest income the loss sustained in selling for $370 the residual rights in the $1,000 loan.

A "pre-paid rent" scheme is ordinarily more complicated. While it would not be an essential feature, it is often the case that the pre-paid rent escapes tax because it is received by an exempt institution. Mr. Howard observed that it was a matter for serious concern that exempt institutions such as charities allow themselves to be used in this way.

A "pre-paid rent" scheme works along the following lines.

A taxpayer wishing to acquire new business premises at a cost of $1 million arranges for an exempt institution to purchase the premises using loan funds supplied by the scheme's promoter. The taxpayer leases the premises from the institution on terms that permit pre-payment and include an option to acquire the premises after the pre-payment for a specified amount, e.g. $250,000. The taxpayer then pays five years' rent in advance amounting to $800,000, and the option to purchase is taken up in the name of an associate of the taxpayer. The exempt institution, having received a total amount of $1,050,000 then repays the loan of $1 million to the promoter together with a fee (in the form of interest) that leaves the institution with a small return for its services.

As an exempt charitable institution it pays no tax on the $800,000 "rent". On the other hand, for an outlay of an additional $50,000 over the $1 million cost of the business premises the taxpayer, who normally would not be entitled to any income tax deduction at all for a straight-out purchase of the premises, claims a deduction of $800,000 for rent paid.

Mr. Howard said that the legislation he has in mind to counter these schemes will be on the lines that, where interest or rent is pre-paid in accordance with an arrangement or understanding to the effect that the taxpayer or an associate can take an assignment of residual rights under a relevant contract or has a right to acquire relevant property, there will be no deduction at all for the amount pre-paid. A relevant contract would be the loan agreement in the case of interest, or a lease agreement in the case of rent. An

* Press Release No. 25 of the Treasurer.

[continued on p. 284]

# India: Amendments to the Finance Bill 1978

*On April 27, 1978 the Finance Minister, Mr. Patel, announced some changes in the proposed Finance Bill 1978 which have been incorporated in the Finance Act. The latter has recently received the assent of the President. The changes pertain, inter alia, to certain advertisement expenses, the export markets development allowance, the deduction of certain investments, the taxation of non-resident Indian citizens and the treatment of certain deposits in banks for capital gains tax purposes.*

*The relevant parts of Mr. Patel's speech are reproduced below:*

The Bill provides for the disallowance, in the computation of taxable profits, of a specified percentage of expenditure incurred by taxpayers on advertisement, publicity and sales promotion. It has been represented that while large enterprises might be able to absorb the impact of this measure, the proposed disallowance will result in hardship in the case of medium and small enterprises. In order to avoid hardship to them, the Bill already provides that no disallowance will be made in cases where the aggregate expenditure on advertisement, publicity and sales promotion does not exceed 20,000 Rs in a year. This has been criticized as being somewhat too low a sum.

With a view to ensuring that genuine small enterprises are not adversely affected by this provision, I propose to raise the monetary limit of 20,000 Rs to 40,000 Rs.

It has been represented that the proposed measure will seriously endanger the existence of small newspapers. In order to ensure that the proposed measure does not result in any fall in the advertisement revenues of such newspapers, I propose to provide that no disallowance will be made in respect of expenditure on advertisement in any newspaper with a circulation not exceeding 15,000.

As there is little scope of any extravagance or wastefulness in statutory advertisements or advertisement for recruitment of staff, I propose to provide also that no disallowance will be made in respect of expenditure on advertisements which fall in these categories.

It has been pointed out that the expressions "publicity" and "sales promotion" are of wide amplitude and should be defined precisely. While an exhaustive definition of these terms is difficult, I propose to clarify that no disallowance will be made in respect of certain items of expenditure, including expenditure on sales conferences, Press conferences and trade conventions; participation in trade fairs and exhibitions; establishment charges, including salaries of staff; catalogues and price lists.

Power is also being taken to add to these items through rules framed by the Central Board of Direct Taxes.

Under an existing provision in the Income Tax Act, entertainment expenditure in excess of specified limits is disallowed in computing the taxable profits. It is proposed to clarify that expenditure on entertainment in connexion with publicity and sales promotion will continue to be disallowed under the existing provision which is more stringent than the provision proposed in the Finance Bill.

The Bill seeks to discontinue the grant of export markets development allowance in relation to expenditure incurred after March 31, 1978. It has been urged that this tax concession has played a useful rôle in diversifying and stimulating India's exports. The process of diversification, is, however, far from complete and continued efforts are required for larger exports of our products. The share of the small-scale sector in these exports is of considerable importance.

It has been represented that in view of the stiff competition in world markets, the export of Indian products is facing challenging problems, which necessitates continued marketing thrusts on the part of our exporters. I have given careful thought to these considerations and have decided to continue the scheme of export markets development allowance with some modifications.

The scheme of export markets development allowance will now be available only to export houses recognized by the Ministry of Commerce: small-scale exporters and consultancy firms. Currently, export markets allowance is granted at the rate of 150 percent of the actual expenditure on development of export markets in the case of widely-held domestic companies, and at the rate of 133.3 percent in the case of other taxpayers.

I propose to reduce the quantum of deduction in the case of widely-held domestic companies from 150 percent to 133.3 percent. It is also proposed to reduce the list of eligible items of expenditure qualifying for deduction under this provision by omitting two of the existing entries.

The Bill provides for a deduction in the computation of taxable income of 50 percent of the amount invested in equity shares of new industrial companies. With a view to providing a stimulus to house building activity, I propose to extend this concession to investment in new equity shares of approved companies established for providing long-term finance for construction or purchase of residential houses in the country.

The Bill seeks to provide that Indian citizens, who are rendering service outside India and who visit their home country during any financial year on leave or vacation, will not be regarded as resident in India in that year in cases where their stay in the country during that year does not exceed 89 days. Under the provision in the Bill, this concession has been restricted to cases where the service of the Indian citizen outside India is sponsored by the Central Government or the terms and conditions of such service have been approved by the Central Government or the prescribed authority. I propose to delete this restrictive condition so that this concession becomes available to all Indian citizens employed outside India, irrespective of whether the service of the individual is sponsored by the Government or the terms and conditions of services have been so approved or not.

The Finance Bill seeks to prove that every person, irrespective of whether he has been assessed to income-tax or not, will have to pay advance tax on a voluntary basis. Under the provisions in the Bill, all taxpayers, including those who have not been previously assessed to income-tax would be required to make an estimate of the advance tax payable by them before the date on which the first instalment of advance tax is due in the case. As it may be difficult for taxpayers who have newly set up a business or profession to make an accurate estimate of the advance tax payable by them early in the accounting year, I propose to provide that new taxpayers, that is, those who have now been previously assessed to income-tax, may continue to furnish, as hitherto, an estimate of advance tax before the date on which the last instalment of advance tax is due in their case.

The Bill provides that fixed deposits with banks made after February 28, 1978 will not be regarded as an eligible mode of investment for the purposes of exemption of long-term capital gains. I had introduced this provision because banks were allowing substantial advance against the security of fixed deposits, with the result that taxpayers who got exemption from capital gains by making such deposits obtained an unduly large benefit without commensurate sacrifice. On a careful consideration of the representations received against this proposal, I have decided to continue fixed deposits with banks as an eligible mode of investment subject to the fulfilment of certain conditions which are intended to ensure that no loan or advance is taken by taxpayers against the security of such deposits for a period of three years.

The various modifications proposed by me will result in a loss of 10.5 crores Rs in a full year and 8.8 crores Rs in 1978-79.

May I now turn to the proposals covering indirect taxes?

A number of honourable members have spoken about the levy of excise duty of two paise per kilowatt hour on electricity generated in the country. I have also received representations from the State Governments, State Electricity Boards and industry.

The imposition of a duty on the generation of electricity was with a view to mobilizing resources needed for the plan particcularly in view of the large investments in the power sector. It has been brought to my notice that one of the problems faced is that power which is generated cannot be fully utilized and is not entirely available to the State Electricity Boards.

This arises because of the use of power for auxiliary consumption as well as because of transmission losses. I must make it clear that since the tax on electricity is a tax on production and not on sales, the losses on account of transmission cannot be taken cognizance of from a strictly legal point of view. However, in view of the practical difficulties involved, I have already exempted the electricity which is used in auxiliary consumption. I propose to go further and give a uniform reduction of 10 percent of the duty payable on the current generated after deducting the auxiliary consumption, thus restricting the levy to 90 percent.

I had already proposed that a rebate of duty would be granted on electricity used for agricultural purposes. In order to simplify the administration of this rebate, I propose to make it available to current supplied by the electricity boards and others at their agricultural tariffs for agricultural purposes.

It has also been urged that there is a time-lag between the production of electricity and the receipt of money from the actual consumers thereof and that therefore collection of duty should be regulated suitably. Keeping the normal time-lag in view, instructions are being issued to allow a period of two months within which the producers could pay the duty.

Certain difficulties have also been expressed regarding the recovery of amounts resulting from this levy from the actual consumers of electricity in respect of production in the first one or two months beginning from March 1. While there would be no case for any waiver of the levy itself, I am instructing the department to allow payment in easy instalments, if need be, of the duty due in those months.

**[continued from p. 282]**

option to acquire the free hold interest in land and buildings is an example of a right to acquire relevant property.

The Government is aware that "pre-paid" schemes can be implemented in relation to outgoings other than interest and rents. The legislation to be introduced will apply the same principles to schemes involving such other outgoings.

The Treasurer went on to refer to another form of avoidance involving, in a broad sense, pre-payment of revenue outgoings between associated parties. The key element in these schemes is that, while the amount concerned is effectively liable to tax in the hands of the recipient, the arrangement is so structured that, although the payer seeks a deduction in the year in which the outgoing is incurred, the recipient claims to have it spread for assessment purposes over the period to which the payment relates. Alternatively, the person to whom the payment is due may claim that it is not "derived" (and thus not taxable) until, after an extended time has elapsed, it is actually paid.

In other words, it is the purpose of the arrangement to achieve a deduction for one party that is not matched by the amount being fully taxable to the other party in the same income year, either by withholding tax or by assessment.

Mr. Howard said that these schemes also need to be curtailed because of the significant deferment of tax that results from them. The legislation he has in mind would be applicable where the outgoing is incurred under an arrangement between associated persons that has a purpose of tax avoidance. Where, in such a situation, an amount is payable in consideration of services to be provided, the deduction would be allowed in the year in which the services are rendered. In cases not involving the provision of services the deduction would not be allowed unless the relevant amount is actually paid over before the income year ends.

The Treasurer stressed that the amending legislation when introduced would apply to payments of interest, rent and other outgoings, under schemes of the type referred to in this statement, incurred after today.

Mr. Howard emphasised that the amendments proposed would not affect pre-payment of interest, rent or outgoings made or incurred in the context of a normal commercial transaction.

# CONFERENCE DIARY

## SEPTEMBER 1978

*32nd Annual Congress of I.F.A.:* I. The Taxation of Extractive Industries; II. The Differences in the Tax Treatment between Local and Foreign Investors and the Effects of International Treaties. Sydney (Australia) September 17-23 (English, French, German, Spanish).

*Management Centre Europe:* International Tax Management (seminar) (subjects include tax treatment on technology import and technology export, valuation of goods for customs duty, VAT and other purposes), Oslo (Norway), September 21 and 22 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Copenhagen (Denmark, September 25-27 (English).

## OCTOBER 1978

*Confédération Fiscale Européenne (CFE):* La Fiscalité en Europe (including: tax harmonization in Europe; taxation of investments in Europe; corporate income tax in Europe with emphasis on the impact of double taxation treaties; net worth tax in Europe; co-operation between tax consultants and other free professions). Strasbourg (France), October 13 and 14 (French, English, German).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (seminar), Brussels (Belgium), November 7-8 (English).

*Seminar Services International:* The International Contracts Symposium (The structure of this Symposium is similar to that of the International Tax Planning Symposium), Zurich (Switzerland), November 15, 16 and 17 (English, French and German).

*Seminar Services International:* The 9th Multi-choice International Tax Planning Symposium (The structure of this Symposium will be similar to that of the 6th, 7th and 8th International Tax Planning Symposiums held respectively in Montreux (1977), Amsterdam (1977) and Zurich 1978)), Amsterdam (Netherlands), November 22, 23 and 24 (English, French and German).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## DECEMBER 1978

*Management Centre Europe:* Multinational Compensation (including legal tax and accounting variations and their impact on financial appraisal of benefit decisions) (Round Table), Brussels (Belgium, December 4-6 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

**FOR FURTHER INFORMATION PLEASE WRITE TO:**

Bureau van de Nederlandse Federatie van Belastingconsulenten (Bureau of The Netherlands Federation of Tax Consultants) Wassenaarseweg 20, 2596 CH Den Haag (Netherlands).

Deutsche Steuerjuristische Gesellschaft e.V.: Classen-Kappelmann-Str. 24, 5000 Köln 41 (German Federal Republic).

Euroforum: Keizersgracht 534, Amsterdam (Netherlands).

Fenedex (Federation for the Netherlands Export): Bezuidenhoutseweg 76a, 2509 LK Den Haag (Netherlands).

Financial Times Ltd. Conference Organisation: Bracken House, 10 Cannon Street, London EC4P 4BY (U.K.).

Inter-American Centre of Tax Administrators: Apartado 215, Panamá 1 (Panama).

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

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

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

Seminar Services International: Promotion Manager, Institute for International Research Ltd., 70, Warren Street, London WIP 5PA (U.K.).

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# Bibliography

# Books

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

## ASIA

### ASIAN INDUSTRIAL EXPANSION

New investment and export opportunities. By Anthony Edwards. London, The Financial Times, Ltd., 1977. 211 pp.
Study of investment opportunities and business operations in Asian countries for West European enterprises. Taxation aspects are dealt with. (B. 50.999)

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3., neubearbeitete Auflage. Nach dem Stande vom 1. Jänner 1978. By Walter Schögl, Werner Wiesner and Wolfgang Nolz. Vienna, Manzsche Verlags- und Universitätsbuchhandlung, 1978. Manzsche Gesetzaufgaben, Sonderausgabe No. 18. 264 pp., ÖS. 194.-.
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By Ylves José de Miranda Guimarães. São Paulo, Editora José Bushatsky, 1977. 153 pp.
This book deals with certain types of taxes (parafiscal) which are normally levied in favor of entities other than the State and its political subdivisions. (B. 15.756)

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(B. 101.093)

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### HANDBUCH DER RÜCKSTELLUNGEN UND RÜCKLAGEN IM STEUERRECHT

By Rolf Mittelbach. Cologne, Peter Deubner Verlag, 1978. 234 pp., DM 48.-.
Handbook discussing the various tax allowed reserves and liability provisions under German law, such as guarantee-provisions, pension reserve, reserve for price increases, replacement reserve, etc. (B. 101.058)

### DER KNOW-HOW-VERTRAG

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# Cumulative Index 1978 - Nos. 1, 2, 3, 4 & 5

# Contents

of the July 1978 issue



**In next issues:**

The German corporation tax reform and the revision of double tax treaties
— by *Dr. Theodor Faist*

Compensation of expatriates transferred to Brazil
— by *Aleksas Juocys*

Recent developments in Australian Federal Fiscal Arrangements
— by *G. Thimmaiah*

Current status of studies and work on tax treaties; LAFTA and Andean Pact
— by *Ramón Valdés Costa*

Tax structure and fiscal policy
Australia: *W.G. Cook*
Indonesia: *Prof. Dr. Rochmat Soemitro SH*
Philippines: *Dr. Angel Q. Yoingco*
Western Samoa: *Earl H. Forbes*

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

# MEXICO

# The Evolution of Mexico's Public Revenue Structure, 1877~1977

by Arthur J. Mann*


The theme of public revenue and tax structure change during the process of economic development has been amply dealt with in economic literature. However, due to the lack of historical time-series data on GNP and consistent revenue series, most studies have employed a cross-sectional approach to analyzing the relationship between revenue structures and the development process. [1] In doing so, they have attempted to formulate certain generalizations with respect to this relationship, generalizations which are felt to be valid if they were applied to time-series data.

The purpose of this paper is to present statistical evidence (in a non-econometric fashion) on the evolution of the Mexican public revenue structure over the past 100 years (1877-1977). During this period of time Mexico experienced a revolution and the structural economic changes associated with the course of economic development, a process well under way by the 1940s. The data will be used in order to verify how well their general patterns conform to the conclusions produced by cross-sectional models of the Hinrichs-type. As will be seen, Mexico's revenue structure has passed through several "stages," and today exhibits many of the characteristics of that of a modern state (with one notable exception).

Table 1 presents aggregate public income and tax figures as a proportion of Mexico's gross domestic product (GDP) for all levels of government over the 1899-1977 period. [2] The figures corresponding to each sub-period are three-year averages for all variables; this is done to smooth out any fortuituous fluctuations which might well affect data taken from any single year. For all years federal government recurrent income and tax income totals are presented separately. Unfortunately, this could not be done for the federal entities (states, municipalities, and the Federal District) in the earlier sub-periods due to the lack of reliable data. Social security tax data do not appear until 1949 - 51 because the first truly national social security program of significant import did not begin operations until 1943. Although it can be justifiably argued that the profits of public enterprises also form part of the public sector's revenue structure (as indirect taxes), they are not included here for several reasons. Of the myriad public enterprises, some are subject to federal budgetary control and some are not; they are being constantly formed, reorganized, and eliminated, thereby creating consistency problems for a data base. Data coverage for all enterprises for all years is not consistent, and in the decade of the 1970s they have run budgetary deficits which have had to be covered by federal government transfers. Moreover, for the sake of international comparisons, they must be excluded.

Table 1 reveals that total recurrent income for all levels of government as a percentage of GDP remained essentially static throughout most of the time period covered. [3] It was not until the latter two decades

* Associate Professor of Economics, University of Puerto Rico in Mayaguez. This paper was done while he was Fulbright Professor of Economics in the Facultad de Economía of the Universidad de Nuevo León in Monterrey, Mexico.

1. See, for example, H.H. Hinrichs, *A General Theory of Tax Structure Change during Economic Development* (Cambridge, Mass.: Harvard Law School, 1966); A. Martin & W.A. Lewis, "Patterns of Public Revenue and Expenditure, " *The Manchester School of Economic and Social Studies*, V. 24 (1956), pp. 203-244; R.A. Musgrave, *Fiscal Systmes* (New Haven: Yale University Press, 1969), Chapts. 4 and 6.
2. This table begins with the 1899-1901 period because the first year for which GDP estimates are available for Mexico is 1895. For sources see Table A-2.
3. The proportions corresponding to the years 1899-1901 should be discounted, for there is evidence that the GDP esti-

(the 1960s and 1970s) that the proportion showed significant upward movement, as social security revenues and federal government revenues provided the push toward higher relative public income levels. Despite efforts to strengthen the federal entity fiscal structures through revenue-sharing schemes, the GDP-share of federal entity income is today equal to what it was in the early 20th century. The GDP-share of federal tax income followed basically the same pattern as the GDP-share of total federal income, with the gap between the two (comprised of non-tax income) narrowing slightly as time progressed.

In part A of Table 2 is presented a percentage breakdown of the principal components of the Mexican federal government revenue structure over the years 1877-1977. Again, all figures refer to three year averages, with the exception of those for 1877. Part B of Table 2 reveals a similar percentage breakdown for all governmental levels combined, but over the shorter 1949-1977 span of years. Most attention will be directed toward Part A in the ensuing discussion. Figure 1 yields a graphical illustration of the trends contained in Part A.

Focus on Part A reveals distinct proportional revenue trends over the past century. Since the Mexican Revolution of 1911-1917, the role of direct internal taxes (principally on the incomes of persons and businesses) has steadily increased. In contrast, the relative role of taxes on international commerce (export and import taxes) has drastically fallen off. However, this drop has not followed a steady downward pattern. Rather, there are two distinctly observable patterns pertinent to these foreign trade taxes. The first decrease followed the revolutionary period, but from the 1920s through the late 1950s a plateau was reached (see Figure 1), as externally-related taxes generated close to 30 percent of total recurrent revenues. It was during the decade of the 1960s that the second downward movement occurred, especially influenced by drastic decreases in export tax revenues. There is really no discernible upward or downward trend in the internal indirect tax proportions in the 20th century (ignoring the unsettled years 1919-1921, which came upon the heels of the revolution). Although prior to this century the indirect tax percentage had risen, both before and after the revolution thes levies produced from one-quarter to two-fifths of the totals, reaching a maximum proportion of 40.9 percent in the years 1939-1941. Finally, with respect to non-tax income, this revenue source has steadily declined in relative importance since the late 1920s. [4]

Part B of Table 2 differs from Part A in that the revenues from all governmental levels naturally change the compositional structure of overall public income. The federal entities do not levy foreign trade taxes, and their revenue structures are not as heavily weighted toward direct taxation. The most important direct tax in their arsenal is the property tax, which is not a federal impost. Non-tax revenue is more important for the federal entities. Of course, the inclusion of social security taxes in Part B makes direct comparisons between Parts A and B more difficult. Of significance is the growing role of national level social security taxes which, if classified as direct taxes, would render Parts A and B much more similar.

The percentage evolution of Mexico's federal government revenue structure (as presented in Part A of Table 2 and in Figure 1) coincides well with the Hinrichs typology of tax structure change during economic development. Taking late 19th century Mexico as in the transitional period toward modernity, during the Porfiriato (1877-1911) the increasing importance of internal indirect taxes and the dominance of international trade taxes are noteworthy. This is not surprising, for the most identifiable tax bases during this period of increasing internal and external commerce and monetization of transactions were the foreign trade sector and the manufacturing and/or commercial sectors, where relatively larger firms began to appear. As can be noted in Table A-2, in the first decade of the 20th century the foreign trade sector generated around one-quarter of GDP, thereby providing a solid "tax handle." In contrast, the primary sector generated over one-third of GDP, and this sector has traditionally provided relatively poor "tax handles." As a consequence, direct taxation is made more difficult (had the desire to employ it existed).

For purposes of analyzing Mexico's tax structure changes after the revolutionary period, at least two distinct phases should be identified. Through the mid-1940s the tax structure had not dramatically changed, in the sense that direct taxes continued to generate low proportions of total revenues and non-tax sources provided over one-fifth of aggregate income; indirect internal taxes did rise proportionally to compensate for the decline in the foreign trade tax proportions, but they were levied on the production and sale of a plethora of items (creating high administrative costs). A highly schedular income tax law had gone into effect in 1925, but evasion was high and administrative efficiency poor. The second phase of Mexico's post-revolutionary tax structure evolution began in the late 1940s, following upon the beginnings the Mexico's economic development (which roughly dates from around 1940). As may be observed in Table 2, after the mid-1940s direct (income) taxes start their most significant propor-

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mates for these years are underestimated (thereby overstating the percentage). The GDP estimates for the 1925-1977 period are taken from the most recent revisions.

4. To emphasize a point made in the tabular notes, this study deals with the *recurrent* income structure of Mexico. It therefore excludes non-recurrent (or non-ordinary) incomes received by the public fisc from the issuance of debt obligations (both external and internal).

tional ascent, while non-tax sources and external taxes (after the mid-1950s) declined in relative importance. Meanwhile, the extremely diverse internal indirect taxes were unified in 1948 under the imposition of a general turnover tax (impuesto sobre ingresos mercantiles), and since then have slightly increased their relative importance. [5]

Thus, after the mid-1940s the evolution of the federal revenue structure generally conforms to the Hinrichs typology. As rapid economic development and structural change took place (see Table A-2), more modern-style indirect taxes tended to predominate over foreign trade taxes (although this phenomenon occurred with a time lag), and direct taxation grew in relative significance at a much faster rate than other types of taxation.

None of these changes is really surprising. As Musgrave has pointed out, [6] there are two ways in which economic factors bear on tax structure development. The changing overall economic structure leads to tax base and "tax handle" modifications, and the economic and socio-political objectives of tax policy additionally change. During the course of economic development internal markets and industry expand, and Mexico's policy of import substitution has further fueled such expansion of internal tax bases. Moreover, the criterion of tax equity has been one factor leading to greater emphasis on direct taxation. For example, the highly schedular income tax law, first introduced in 1925, was converted (in 1965) into an essentially global tax in order to reduce inequities and increase revenues.

Despite the modernistic aspects of the Mexican federal govenment's revenue breakdown over the past decade or so (i.e., a low proportion of total revenues from non-tax and foreign trade sources and relatively high proportions from direct and indirect internal sources), one aspect does not fit the pattern. Both total revenue and tax revenue and as a proportion of GDP are relatively low, even for a developing country. Table 1 reveals that in the 1975-1977 period the total recurrent revenues of all governmental levels in Mexico (including social security) reached only 16.0 percent of GDP. For the same time span the tax ratio (tax revenues divided by GDP) was only 14.5 percent.

That these ratios represent extremely low levels of resource capture by the public fisc is evident on an internationally comparative basis. Using the years 1969-1971 as the point of reference, an International Monetary Fund study found that the average tax ratio for a sample of 47 developing countries was 15.1 percent. [7] The corresponding tax ratio for Mexico during the same time (see Table 3) was 8.9 percent (excluding social security), [8] whereas that for a sample of developed countries was 26.2 percent. In terms of the ratios of different types of taxes to GDP, Mexico falls below the mean value on all counts. While Table 3 reveals that in 1969-1971 direct Mexican taxes for all governmental levels comprised 4.3 percent of GDP, the 47 country average was 5.4 percent. In terms of indirect internal taxes and foreign trade taxes the ratios for Mexico were 3.8 percent and 0.8 percent respectively, whereas the corresponding average ratios were 4.6 percent and 4.7 percent respectively.

In summary, there is no doubt that Mexico, even though it possesses relatively modern tax structure characteristics (in the compositional sense), lags far behind the "norm" in transferring private sector incomes toward the public secor. This phenomenon has been essentially due to public policy seeking to stimulate private investment by maintaining low (effective) [9] tax rates. Moreover, tax policy has discriminated in favor of certain economic sectors to the detriment of others. Sectors which absorb relatively high proportions of the economy's aggregate value-added (e.g., large-scale agriculture, construction, and services) are lightly taxed, while the opposite is true in other sectors (transport, manufacturing, and mining). [10] Thus, Mexican tax policy might be characterized as an economic development policy rather than one more oriented toward the raising of revenues.

That such an orientation may be changing might be concluded from the last column of Table 3. Taking the tax ratio as an index of effort, the jump in Mexico's tax ratio between 1969-1971 and 1975-1977 reflects increased tax effort. Certainly an increased tax burden is called for, as is evidenced by the data presented in the last two colums of Table A-2. Since the late 1950s government expenditures have grown at a faster rate that government revenues (tax and non-tax), thereby generating a proportionally rising budget deficit. One of the factors affecting the 1976 peso devaluation was precisely this deficit. and the restriction of foreign credits. At any rate, future (upward?) changes in the tax ratio will, of course, influence the composition of the revenue structure.

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5. It is expected that this multi-stage turnover tax soon will be converted into a multi-stage value-added tax.
6. Musgrave, op.cit., Chapter 5.
7. R.J. Chelliah, H.J. Bass, and M.R. Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-71," *IMF Staff Papers*, V.22 (March, 1975), pp. 187-205. Although the IMF study employs GNP in the denominator whereas this study uses GDP, the difference is much too insignificant to invalidate the subsequent comments.
8. The Mexican tax ratio presented in the IMF study is 7.1 percent, but it excluded federal entity taxes. All subsequent ratios for Mexico presented below are taken from data developed in this paper.
9. Although statutory rates might be high, evasion, administrative inefficiency, and preferential treatment make the effective rates substantially lower.
10. These conclusions are taken from data presented in Banco de México, *Cuentas nacionales y acervos de capital consolidados y por tipo de actividad económica, 1950-1967*; and in Secretaría de Hacienda y Crédito Público, *Cuenta de la hacienda pública federal.*

## TABLE 1

**Public recurrent income a) and tax income as proportion of GDP b), all levels of government, Mexico, 1899-1977.**

| Peroid f) | Federal Government: Total recurrent income | Federal Government: Total tax income | Federal entities c): Total recurrent income | Federal entities c): Total tax income | National social security taxes d) | All Government levels: Total recurrent income e) | All Government levels: Total tax income |
|---|---|---|---|---|---|---|---|
| 1899-1901 | 6.4 | 5.2 | 3.8 | N.A. | - | 10.2 | - |
| 1909-1910 | 4.5 | 3.4 | 2.3 | N.A. | - | 6.8 | - |
| 1929-1931 | 6.8 | 5.1 | 3.0 | N.A. | - | 9.8 | - |
| 1939-1941 | 6.5 | 5.2 | 2.9 | N.A. | - | 9.4 | - |
| 1949-1951 | 8.1 | 6.7 | 2.2 | 1.7 | 0.5 | 10.8 | 8.9 |
| 1959-1961 | 7.0 | 6.2 | 2.5 | 1.7 | 1.1 | 10.6 | 8.9 |
| 1969-1961 | 8.1 | 7.2 | 3.0 | 1.8 | 1.9 | 13.6 | 10.8 |
| 1975-1977 | 11.1 | 10.3 | 2.3 | 1.6 | 2.6 | 16.0 | 14.5 |

*Notes:* May not sum horizontally to total due to rounding.
N.A. Not available.
a) Excludes income from non-recurrent debt sources; for further comment, see note "a" to Table A-1 of the Appendix.
b) Gross domestic product; 1976 and 1977 data are preliminary.
c) States, municipalities, and Federal District.
d) IMSS and ISSSTE. See note "h" to Table 2.
e) Includes social security taxes.
f) Three-year averages with exception of 1909-1910.

*Sources:* See the Appendix for the sources to Tables A-1 for income data; and the sources to Table A-2 for GDP data.

## FIGURE 1

**Changes in the percentage composition of the Mexican federal government revenue structure, 1879-1977.**

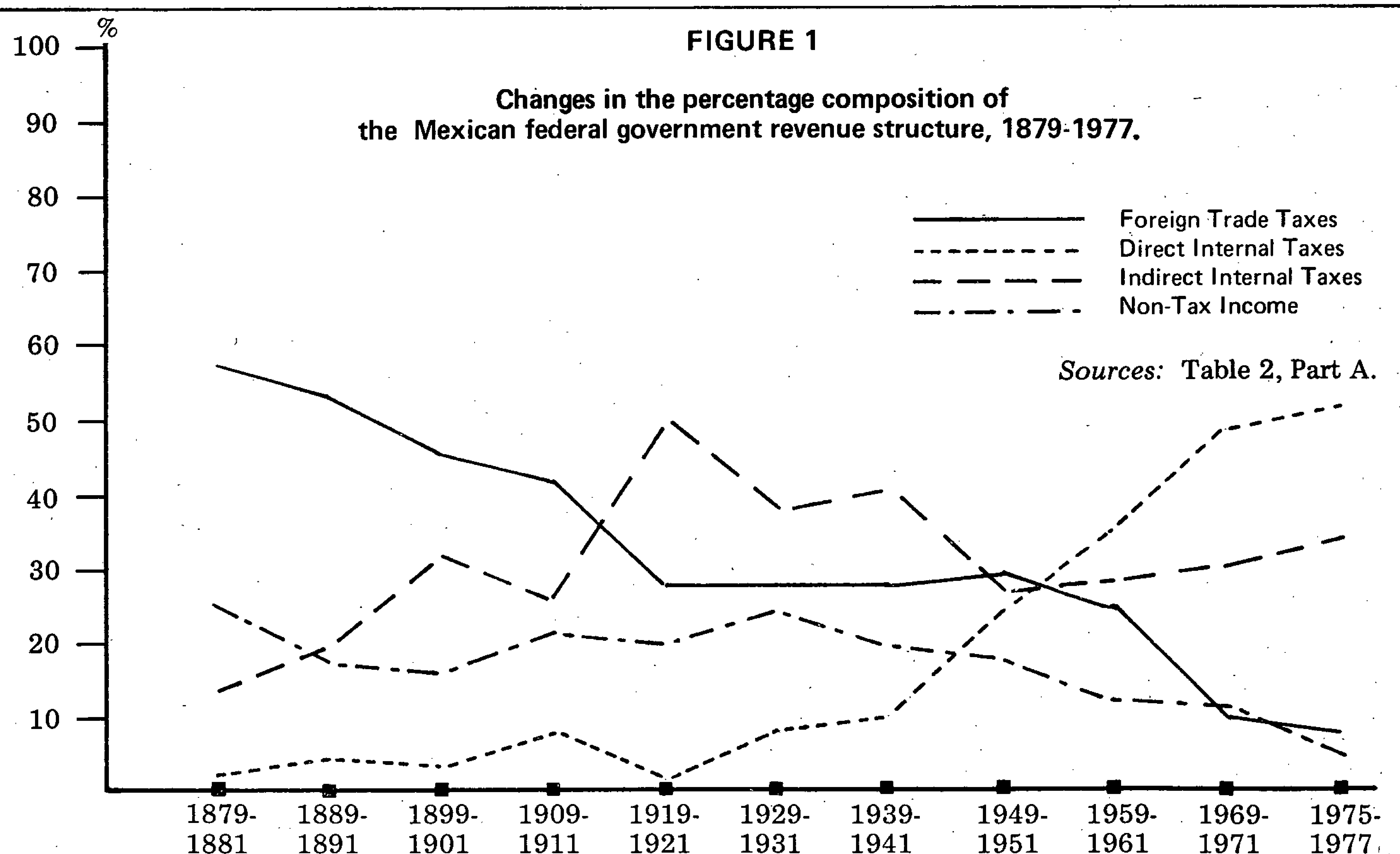

**TABLE 2**

**The percentage evolution of the recurrent income a) structure of Mexico, 1877-1977.**

*(all figures in percents)*

A. FEDERAL GOVERNMENT

| Period b) | Direct internal taxes c) | Indirect internal taxes d) | Foreign trade taxes e) | Non-tax income f) | Total |
|---|---|---|---|---|---|
| 1877 | 2.2 | 14.5 | 52.0 | 31.3 | 100.0 |
| 1879-1881 | 2.3 | 14.0 | 59.1 | 24.6 | 100.0 |
| 1889-1891 | 4.6 | 20.1 | 56.3 | 19.0 | 100.0 |
| 1899-1901 | 4.5 | 32.0 | 45.1 | 18.4 | 100.0 |
| 1909-1911 | 7.9 | 26.6 | 42.8 | 22.7 | 100.0 |
| 1919-1921 | 0.5 | 51.8 | 28.3 | 19.4 | 100.0 |
| 1929-1931 | 7.9 | 38.8 | 28.7 | 24.6 | 100.0 |
| 1939-1941 | 10.5 | 40.9 | 28.8 | 19.8 | 100.0 |
| 1949-1951 | 26.1 | 27.2 | 29.7 | 17.0 | 100.0 |
| 1959-1961 | 35.2 | 27.7 | 24.7 | 12.4 | 100.0 |
| 1969-1971 | 47.9 | 30.5 | 10.1 | 11.5 | 100.0 |
| 1975-1977 | 48.5 | 34.4 | 9.8 | 7.3 | 100.0 |

B. ALL LEVELS OF GOVERNMENT

| Period b) | Direct internal taxes g) | Indirect internal taxes | Foreign trade taxes | Non-tax income | Social security taxes h) | Total |
|---|---|---|---|---|---|---|
| 1949-1951 | 23.3 | 32.4 | 22.2 | 17.5 | 4.6 | 100.0 |
| 1959-1961 | 27.4 | 30.1 | 16.4 | 15.7 | 10.4 | 100.0 |
| 1969-1971 | 33.5 | 29.2 | 6.3 | 16.6 | 14.4 | 100.0 |
| 1975-1977 i) | 36.1 | 32.0 | 6.8 | 9.2 | 15.9 | 100.0 |

*Notes:*

a) Excludes income from non-recurrent debt sources. For further comment, see note "a" to Table A-1 of the Appendix.

b) Three-year averages with the exception of 1877.

c) For the period 1877-1911 these included estate and gift taxes and federal property taxes. Subsequently, they include income taxes on persons and businesses; the property tax was levied at lower governmental levels.

d) Sales, transactions, and production taxes.

e) Import and export taxes.

f) Administrative fees and charges, property income, and fines and interest.

g) Income, property, and capital taxes.

h) IMSS (Mexican Institue of Social Security) and ISSSTE (Security and Social Services Institue of Government Employees). IMSS began operations in 1943 and ISSSTE in 1959. Although there are many other social security funds financed through tax-like charges, these two represent by far the most important funds at the national level. The government contribution to both funds is excluded.

i) The federal entity figures are averages of 1974-75 due to the unavailability (at the time of writing) of later data.

*Sources:* See sources to Table A-1 of the Appendix.

# APPENDIX

## TABLE A-1

**Recurrent income a) of the government of Mexico, 1877-1977.**

*(millions of current pesos)*

| Period b) | Federal Government | | Federal Entities c) | | National social security taxes d) | All government levels | |
|---|---|---|---|---|---|---|---|
| | Total income | Tax income | Total income | Tax income | | Total income | Tax income |
| 1877 | 17.9 | 12.3 | N.A. | N.A. | - | - | - |
| 1879-1881 | 21.5 | 16.2 | N.A. | N.A. | - | - | - |
| 1889-1891 | 36.8 | 29.8 | 27.0 | N.A. | - | 63.8 | - |
| 1899-1901 | 62.5 | 51.0 | 37.4 | N.A. | - | 99.8 | - |
| 1909-1911 | 105.4 | 81.4 | 54.8 | N.A. | - | 160.2 | - |
| 1919-1921 | 216.3 | 174.3 | 75.4 | N.A. | - | 291.7 | - |
| 1929-1931 | 292.6 | 220.6 | 130.0 | N.A. | - | 422.6 | - |
| 1939-1941 | 516.5 | 413.9 | 230.3 | N.A. | - | 746.8 | - |
| 1949-1951 | 3365.5 | 2793.9 | 929.6 | 713.6 | 208.8 | 4,503.9 | 3717.3 |
| 1959-1961 | 10,479.2 | 9169.4 | 3663.6 | 2492.1 | 1644.0 | 15,786.8 | 13,305.5 |
| 1969-1971 | 33,536.7 | 29,688.0 | 12,374.3 | 7329.0 | 7815.0 | 53,726.0 | 44,832.0 |
| 1975-1977 | 143,245.0 | 132,846.0 | 29,475 e) | 21,034 e) | 32,839.0 | 205,559.0 | 186,719.0 |

N.A. - Not available

*Notes:*

a) Excluding income received from debt emissions. Double-counting eliminated by excluding transfers between levels. Federal entity income from revenue-sharing ("participaciones") counted as income only at the entity level, for it is "owned" income at this level. Income is defined in *net* terms ("ingresos efectivos"), *not* in gross terms.

b) All figures are three-year averages calculated to smooth out temporary fluctuations due to unusual circumstances.

c) States, municipalities, and the Federal District.

d) IMSS and ISSSTE.

e) 1974-75. As of the time of writing, 1976 data were not available.

*Sources:*


1. Banco de México, Indicadores económicos (monthly since 1972).
2. Id. Informe anual (1950-1963).
3. Colegio de México. (1965) Estadísticas económicas del Porfiriato: Fuerza de trabajo y actividad económica por sectores. México City.
4. Comisión Mixta. (1953) El desarrollo económico de México y su capacidad para absorber capital del exterior. Mexico City: Nacional Financiera.
5. Cuenta pública del Distrito Federal. Various years.
6. Reynolds, C.W. (1970) The Mexican Economy: Twentieth-Century Structure and Growth. New Haven: Yale Univ. Press.
7. Rosas Figueroa, A. and Santillán López, R. (1962) Teoría general de las finanzas públicas y el caso de México. México City: UNAM.
8. Secretaría de Hacienda y Crédito Público. Cuenta de la hacienda pública federal. Various years.
9. Id. Dirección General de Estudios Hacendarios. Departamento de Estudios Económicos. Work sheets and data specially prepared for the author.
10. Id. Indicadores Tributarios.
11. Secretaría de Industria y Comercio. Anuario estadístico. Various years.
12. Secretaría de Programación y Presupuesto. (1977) Información económica y social básica. México City.
13. Id. Dirección General de Estadística. Oficina de Finanzas, Work sheets.
14. Servin, A. (1956) Las finanzas públicas locales durante los últimos cincuenta años. México City.
15. Servin, A. (1942) Evolución técnica del sistema impositivo federal. México City: Fondo de Cultura.

**TABLE A-2**
**Selected economic indicators, Mexico, 1900-1976.**

| Year | Constant peso per capita GDP a) | Per capita GDP in current U.S. dollars b) | Sectorial proportions of GDP c) | | | Foreign trade as % of GDP e) | Government expenditures f) as % of GDP | Federal government deficit as % of GDP |
|---|---|---|---|---|---|---|---|---|
| | | | Primary d) | Manufacturing | Commerce | | | |
| 1900 | 1216 | 34 | 35.2 | 16.5 | 20.6 | 29.9 | 10.0 | (0.7) g) |
| 1910 | 1535 | 82 | 34.7 | 15.8 | 20.4 | 20.0 | 5.9 | (0.5) g) |
| 1930 | 2076 | 118 | 22.3 | 14.6 | 23.1 | 18.4 | 8.9 | (0.2) g) |
| 1940 | 2376 | 73 | 19.3 | 15.4 | 30.9 | 21.0 | 9.8 | 0.6 |
| 1950 | 3230 | 178 | 19.1 | 17.1 | 31.6 | 21.6 | 9.4 | (0.7) g) |
| 1960 | 4320 | 344 | 15.9 | 19.2 | 31.2 | 15.1 | 10.4 | 0.6 |
| 1970 | 6042 | 682 | 11.6 | 22.8 | 31.8 | 10.8 | 12.7 | 1.2 |
| 1976 | 6569 | 1303 | 8.9 | 23.2 | 30.9 | 11.8 | 18.7 | 4.6 |

*Notes:*
a) Pesos of 1960.
b) Converted at the official exchange rates.
c) Constant prices.
d) Agriculture, livestock, forestry, and fishing.
e) Merchandise exports and imports in proportion to GDP.
f) Includes net expenditures of the federal government and of the state, municipal, and Federal District governments. Given the unavailability of federal entity expenditure data for 1976 and 1977, the 1975 figure was used for all levels. Transfers between levels were counted only once.
g) Budget surplus.

*Sources:*
GDP data (1900 and 1910) from Leopoldo Solís, *La realidad económica mexicana: retrovisión y perspectivas* (México: Siglo Veintiuno, 1976); GDP (1930-1970) from Banco de México, *Estadísticas de la oficina de cuentas de producción, 1960-1976* (México: 1977).
Exchange rate data from Nacional Financiera, *Statistics on the Mexican Economy* (México: 1977).
Sectorial proportions and foreign trade data from same sources as GDP data.
Government expenditure and deficit data from Table A-1 sources.

**TABLE 3**

**The principal tax categories a) as a proportion of gross domestic product, Mexico 1929-1977.**

| Period c) | Federal Government | | | All Government levels b) | | | | Total taxes, including social security d) |
|---|---|---|---|---|---|---|---|---|
| | Direct | Indirect internal | Foreign trade | Direct | Indirect internal | Foreign trade | Social security | |
| 1929-1931 | 0.5 | 2.6 | 1.9 | - | - | - | - | - |
| 1939-1941 | 0.7 | 2.7 | 1.9 | - | - | - | - | - |
| 1949-1951 | 2.1 | 2.2 | 2.4 | 2.5 | 3.5 | 2.4 | 0.5 | 8.9 |
| 1959-1961 | 2.5 | 2.0 | 1.7 | 2.9 | 3.2 | 1.7 | 1.1 | 8.9 |
| 1969-1971 | 3.9 | 2.5 | 0.8 | 4.3 | 3.8 | 0.8 | 1.9 | 10.8 |
| 1975-1977 | 5.4 | 3.8 | 1.1 | 5.8 | 5.1 | 1.1 | 2.6 | 14.5 |

*Notes:*
a) See notes "c" through "i" of Table 2 for definitions.
b) Federal government and federal entities.
c) Three-year averages.
d) May not sum horizontally to totals due to rounding.

*Sources:* See sources to Table A-1 and A-2 of the Appendix.

# Legal Regulation of Taxes, Levies and Fees in the Czechoslovak Socialist Republic

by Dr. Milan Bakes

## PART 2

### III. REGULATION OF TAXES PAID BY CITIZENS

As in most Eastern European countries the Czechoslavak system of taxes paid by citizens is a schedular one, i.e. there are a number of separate categories of taxable income which have their own rates and their own provisions.
The following income taxes are levied in Czechoslovakia:
— wage tax;
— tax on earnings from literary and artistic work;
— land tax;
— tax on citizens' income from agricultural production;
— general citizens' income tax;
— house tax.

#### A. Wage tax [16]

In respect of the total yield and some other factors, the wage tax occupies the most important position in the system of taxes paid by citizens.
The increase and reduction percentages of the wage tax are governed by another Government Ordinance. [17]

*Taxpayers* of the wage tax are natural persons working in Czechoslovakia, with some exceptions laid down by the law.

*Remitter* of the wage tax is the corporate or natural person paying out wages (mostly organisations).

*Subject to the tax is wage for work done*, under which is to be understood:
a. all the taxpayer's earnings from employment or in connection therewith;
b. function emoluments of persons receiving remuneration for the performance of a function not performed within employment;
c. receipts from occupations performed in a relationship similar to employment.

The above income is subject to the wage tax regardless of whether the income is regularly recurring or incidental or once-and-for-all payment; also irrelevant is whether it is paid in money or kind. Reimbursements of business expenses are not wages.

Not subject to the wage tax are earnings of members of the Uniform Agricultural Cooperatives and of persons continually working in such cooperatives, whether paid in money or kind. Such remunerations are also exempt from the citizens' income tax from agricultural production.

*Exempt* from the wage tax are, further:
— sickness insurance benefits as well as child allowances, education allowances and similar benefits granted for children not having their own income;
— rewards for inventions, discoveries and rationalisation proposals and rewards for resolving State research and thematic tasks, etc., up to the amount of 20,000 Kcs for each one of them;
— some remunerations in money and kind and presents to employees in connection with their service, up to the amount of 2,000 Kcs per year;
— remunerations of National Committee officials (exempt is one fifth);
— students' and scientific workers' scholarships (exempt is the sum of 600 Kcs monthly);
— remunerations for school agricultural aid team work and hop picking and other income.

*Assessment basis* is the gross wage paid to the taxpayer in the payroll period.
The tax is computed on a sliding progressive *rate* scaled from 5 to 20 percent. From the 2,400 Kcs monthly wage limit, the 20 percent rate continues linearly. The tax computed in this manner is the basic tax and applies to taxpayers maintaining two persons. For other taxpayers the tax is increased by 35 to 60 percent or reduced by 30, 50 and 70 percent, the increase depending on age and sex.

The basic wage tax table (i.e. for employees maintaining two other persons) is as follows:

| Monthly wage (in Kcs) | Tax due | | | | |
|---|---|---|---|---|---|
| | Kcs | | % | | Kcs |
| 1 – 300 | | | 5 | | |
| 301 – 400 | | | 8 | | |
| 401 – 600 | 32 | + | 10 | for any sum over | 400 |
| 601 – 800 | 52 | + | 11 | for any sum over | 600 |
| 801 – 1,000 | 74 | + | 12 | for any sum over | 800 |
| 1,001 – 1,200 | 98 | + | 13 | for any sum over | 1,000 |
| 1,201 – 1,400 | 124 | + | 14 | for any sum over | 1,200 |
| 1,401 – 1,600 | 152 | + | 15 | for any sum over | 1,400 |
| 1,601 – 1,800 | 182 | + | 16 | for any sum over | 1,600 |
| 1,801 – 2,000 | 214 | + | 17 | for any sum over | 1,800 |
| 2,001 – 2,400 | 248 | + | 18 | for any sum over | 2,000 |
| over 2,400 | 320 | + | 20 | for any sum over | 2,400 |

16. The wage tax is based upon Law No. 76/1952, as amended by Laws No. 71/1957 and No. 90/1968 and on Regulatory Decree No. 161/1976.
17. Ordinance No. 40/1953 as amended by Ordinance No. 112/1953.

Recognised as *maintained persons* are:
- wife (husband), unmarried wife (husband), children under age and adopted children living with the taxpayer in his home regardless of whether they have their own income and to how much it amounts;
- of age children and other persons, provided they have no income of their own exceeding 620 Kcs a month and either live with the taxpayer permanently in his home and the taxpayer provides their maintenance or if they do not live with him and the taxpayer provides them with a regular monthly allowance at least equal to the tax relief, but not less than 100 Kcs a month;
- of and under age children of a divorced or separated couple and children born out of wedlock are recognised exceptionally also to the taxpayer, if they do not belong to his household but if he pays their maintenance allowance, it being presumed in the instance of age children and wives that their income does not exceed 620 Kcs a month.

Of all the children, both of and under age, for whom child allowances or education allowances are paid, only one child is considered as a maintained person by a taxpayer. In the instance of a taxpayer paying maintenance allowances for his children, all the children are considered as maintained persons.

In addition to the persons actually maintained, in some instances other, so called fictitious, maintained persons are recognised to the taxpayer's benefit. This concerns widowed, divorced or separated from husband (wife) taxpayers and single taxpayers having in their care at least one child, to whom one extra person is counted, and further, taxpayers who are disabled or who maintain a disabled person (one person in case of partial disability and two in case of permanent disability), widows of killed members of the resistance movement abroad or after the war, political or national persecution victims, to whom one extra maintained person is counted throughout their widowhood.

The principle underlying the concept of maintained persons is that one and the some person may be recognised as maintained by only one taxpayer and that the taxpayer may claim the maintained persons allowance only from one tax remitter. The other tax remitters withhold the tax as if the taxpayer were not maintaining any person.

To some income subject to the wages tax is applied *lump sum taxation* (e.g. in the case of external workers on the basis of contracts for work done outside their employment, or in the case of students) or *separate taxation* (e.g. in respect of shares in the economic results, loyalty bonuses).

## B. Tax on earnings from literary and artistic work 18

*Taxpayers* of the tax on earnings from literary and artistic work are:
- authors of literary and artistic works;
- performing artists;
- widows and under age children of the above persons receiving income from inherited copyright or from performing artists' rights throughout their widowhood or during the minority of the deceased's children.

*Remitters* of tax are the organisations paying the taxpayer for artistic works or performances or for the use of such works.

Object of the tax on earnings from literary and artistic work is:
- earnings from creative literary or artistic work;
- earnings from the artistic work of performing artists.

Earnings of authors and performing artists are subject to the tax on earnings from literary and artistic work only if the artistic work is not performed under a service contract or is performed for the taxpayer's employer but not in the branch which is the object of his service contract.

*Assessment basis* of the tax in the instance of authors and performing artists is the difference between the total income subject to tax earned in the calendar year and the deductions allowed. In other instances, i.e. for the income from inherited copyright or performing artists' rights, the assessment basis is the gross income received in the calendar year.

The allowed deductions from income are:
a. costs connected with the creation of the work or with the artistic performance, amounting to 20 - 60 percent;
b. contributions from rewards to cultural funds amounting as a rule to 2 percent;
c. the sum of 6,000 Kcs for each person maintained by the taxpayer in respect of whom no wages tax relief was granted.

Regarded as maintained persons are the wife (unmarried wife) or husband (unmarried husband), children and parents (the taxpayer's own as well as the other married or unmarried partner's) provided they have no income of their own exceeding 7,440 Kcs a year, live with the taxpayer in his home, the taxpayer providing their board, lodging and clothing. Of the children, in respect of whom child allowances or education allowances are payable, only one child is recognised as in the case of wages tax. In addition, maintained persons may include the wife, husband and children not having their own income exceeding 7,440 Kcs a year, though they do not live with the taxpayer in his home, if the taxpayer pays alimony established or approved by a court of justice.

The following tax table applies to income from literary and artistic work:

| Annual income (in Kcs) | Annutal tax Kcs | | % | | Kcs |
|---|---|---|---|---|---|
| 1 – 3,000 | | | 3 | | |
| 3,001 – 6,000 | 90 | + | 5 | for any sum over | 3,000 |
| 6,001 – 10,000 | 240 | + | 8 | for any sum over | 6,000 |
| 10,001 – 25,000 | 560 | + | 14 | for any sum over | 10,000 |
| 25,001 – 50,000 | 2,660 | + | 20 | for any sum over | 25,000 |
| over 50,000 | 7,660 | + | 33 | for any sum over | 50,000 |

The tax rate is progressive from 3 to 33 percent. In respect of taxpayers whose net yearly income does not exceed 20,000 Kcs a lump sum rate of 3 percent is

18. This tax is based upon Law No. 36/1965, as amended by Law No. 160/1968.

withheld from each individual remuneration after cost and cultural fund contribution adjustment. This rate is also applied to tax contributions to periodicals, broadcasting and television, provided the fee does not exceed 1,000 Kcs.

## C. Agricultural tax

The agricultural tax is governed by the above mentioned Agricultural Tax Act and the regulatory ordinance thereto.[19]

This Act also amended the House Tax Act,[20] thus excluding house gardens which were made subject to the agricultural tax.

The agricultural tax paid by citizens embodies two components — land tax, common to organisations and citizens, and tax on the citizens' income from agricultural production, paying solely to natural persons.

### 1. *Land tax*

The land tax is levied on citizens along the same principles as on organisations. It is paid by all users of the land which is subject to the tax.

*Not included* in the assessment basis are plots next to family houses and recreation chalets, if the area does not exceed 800 square metres in respect of family house plots and 400 square metres in respect of recreation chalet plots.

### 2. *Tax on citizens' income from agricultural production*

*Taxpayers* are citizens engaged in agricultural production for their own or for joint account. Concerned are above all farmers working their own farms and, further, other citizens engaged in vegetables and animal production as a secondary business in addition to their principal employment.

In respect of members of Uniform Agricultural Cooperatives and the staff of State agricultural organisations, only income from the cultivation of special cultures and from specialised animal production is taxable.

*Object* of the tax is not the cultivation of special cultures and specialised animal production which after deduction of the expenses incurred produces an income exceeding 20,000 Kcs a year or would produce such income if properly managed and in normal climatic conditions. Income from such activities is subject to the citizens' income tax.

Assessment basis for normal agricultural production is established in accordance with average yield standards, and for specialised vegetable and animal production in accordance with the actual net income obtained. Average yield standards express presumed yearly income from normal agricultural production computed per hectare of land. Their amount is set down in the Annex to the Act depending on the various "natural stations", i.e. depending on climatic, soil and terrain factors.

Assessment basis of the tax on income from the cultivation of special cultures and from specialised animal production is computed from the actual income after deduction of the expenses incurred to obtain such income. The total basis is thus the sum total of the income subject to the tax computed according to the average yield standards and of the actual net income from specialised agricultural production. Income from incidental business and secondary production subject to agricultural tax is not included in the assessment basis, but increases the basic tax computed.

The tax rate is sliding progressive, ranging from 5 to 30 percent. Such basic tax is applicable to a taxpayer maintaining one child under age. For taxpayers with no under age children the tax is increased by 10 percent. Other persons than children under age are not considered as maintained persons for the purpose of the agricultural tax.

In some instances provided by the Act the basic tax may be adequately increased or reduced, at most by 50 percent at the discretion of the assessing authorities.

## D. Citizens' income tax[21]

*Taxpayers* of the citizens' income tax are citizens having income subject to the tax arising from sources in the territory of Czechoslovakia.

Taxed with the citizens' income tax is all the income of the citizens which is not subject to the wages tax, to the tax on income from literary and artistic work and to the tax on the citizens' income from agricultural production.

*Subject to the tax* is, in particular, the following income:

- receipts from privately operated trade, crafts and other gainful occupations, including receipts from small services rendered and repairs effected on the basis of a permit issued by a National Committee, and income earned on the basis of work done outside employment service on the basis of agreements made with organisations pursuant to Section 232 of the Labour Code, provided such work is done by the citizen for his own account;
- receipts from privately operated specialised agricultural, vegetable and animal production exceeding, after deduction of the expenses incurred, 20,000 Kcs a year or which would exceed that amount if properly managed and in normal climatic conditions, and further receipts from incidental activities and secondary production not being of a merely complementary nature in relation to the basic agricultural production;
- income from liberal professions (from private medical practice, from private business of architects and designers, from private teaching in any branch, etc.);
- receipts from immovables, in particular from buildings in personal and private ownership (rent from flats, from non-dwelling premises), or from land (rent from gardens, from agricultural plots);
- income from other property and rights (e.g. income from inherited copyright and from the sale of inherited objects of art made by the deceased, if his widow or children under age are not inheritors, in-

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19. See note 13, supra.
20. See III. E, infra.
21. This tax is levied on the basis of Law No. 145/1961 and Regulatory Decree No. 146/1961 to that Law.

terest on bonds and loans, receipts from subletting, from letting movables, etc.);
- receipts from speculative sales, i.e. sales of objects acquired by citizens with the intention to resell or exchange them at a profit.

In determining the object of the citizens' income tax it is necessary to start from the principle that all the income of citizens is subject to tax, provided it is not exempt from tax under special regulations.

*Not subject* to the citizens' income tax are financial means acquired:
- from insurance institutions as damages received from personal, property or compulsory insurance;
- by inheritance, donation or other gratuitous presentation;
- as indemnity for damage suffered;
- by sale of property belonging to the taxpayer, provided it is not a speculative sale;
- as winnings — on lotteries, deposit books, further receipts from Sazka (football and other sports pools) and Sportka (lottery) and other games.

Not subject to the citizens' income tax are further child allowances, financial means exempt from any tax pursuant to special regulations (State prizes, etc.) and allowances granted by cultural funds. [22]

*Assessment basis* is the taxpayer's total net income in the calendar year for which the tax is assessed. The tax is computed as the difference between the taxpayer's total income acquired in the year and the expenses incurred for its acquisition. Considered as expenses for the purpose of the citizens' income tax are only expenses immediately linked with some of the income sources and which were necessary for the acquisition of the income from such particular source.

*The rate* of the tax is sharply progressive, scaled from 5 to 65 percent of the assessment basis.
In the instance of income from gainful occupations carried out as a trade the tax is increased by up to 30 percent, but at least 800 Kcs. Invalid tradesmen or persons having attained the age of 65 years may, on the other hand, be granted part or full tax exemption. The decision on the extent of tax increase as well as the grant of exemption is left to the jurisdiction of the National Committees.

The tax table which applies to the citizen's income tax is as follows:

| Annual income (in Kcs) | Annutal tax Kcs | | % | | Kcs |
|---|---|---|---|---|---|
| 1 – 3,000 | | | 5 | | |
| 3,001 – 6,000 | | | 10 | | |
| 6,001 – 8,000 | 600 | + | 15 | for any sum over | 6,000 |
| 8,001 – 12,000 | 900 | + | 25 | for any sum over | 8,000 |
| 12,001 – 18,000 | 1,900 | + | 35 | for any sum over | 12,000 |
| 18,001 – 28,000 | 4,000 | + | 45 | for any sum over | 18,000 |
| 28,001 – 46,000 | 8,500 | + | 55 | for any sum over | 28,000 |
| over 46,000 | 18,400 | + | 65 | for any sum over | 46,000 |

As with other income taxes paid by the citizens, to the citizens' income tax is also applied the social point of view and the tax is increased or reduced with respect to the number of persons maintained by the taxpayer. The category of maintained persons is similar to that in the instance of the wage tax, with the difference that persons not living in the taxpayer's home and so-called fictitious maintained persons are not recognised as maintained persons. The maximum income limit of any maintained person may not exceed 7,440 Kcs a year. The tax computed according to the rate is applicable to taxpayers maintaining two or three persons. To taxpayers maintaining no extra person or one person the basic tax is increased by 40 and 20 percent respectively and taxpayers with four or more maintained persons are granted a 30 percent tax reduction, with a maximum of 1,200 Kcs. The highest tax that may be charged, including increase in respect of the number of persons maintained and trade increment, amounts to 85 percent of the assessment basis.

In the instance of small tradesmen, of persons providing small repairs and services on the basis of permits issued by National Committees, of peddlers and hawkers and of popular entertainment operators (swings, merry-go-rounds, shooting ranges), where the assessment of the tax basis, i.e. of the actual net income, is very difficult as such taxpayers usually do not keep records of their receipts and expenses with proper vouchers, the tax may be charged as a lump sum without assessment of the tax basis.

### E. House tax [23]

*Taxpayer* of the house tax is the owner of the building if the owner is a citizen or a non-socialist organisation. In the case of buildings to which the right to use still appertains, the user is taxpayer. Joint building owners are liable to pay the tax jointly and severally.

*Exempt* from the house tax are:
- diplomatic representatives of foreign countries accredited in the CSSR, as well as other persons enjoying diplomatic privileges and immunity in respect of houses or their parts which they use;
- international organisations and their employees, being entitled to exemption under international treaties and agreements.

The tax *object* is buildings constructed for lasting purposes. Subject to the tax are dwelling houses, production buildings, garages, as well as chalets and garden summer houses, if their built-up area is at least 8 square metres. Together with such buildings the built-up area around them and courtyards are also subject to the house tax. Not subject to the house tax are houses in socialist ownership. Buildings owned by other than socialist organisations are subject to the house tax, but church and religious societies' buildings are exempt.

*Assessment basis* for houses in personal ownership is the built-up area of the building, for buildings in private ownership the rent and price of user.

22. Sec. 4 of the Copyright Act, No. 35/1965.
23. The tax is levied on the basis of Law No. 143/1961 as amended by Law No. 129/1974 and on the basis of Regulatory Decree No. 144/1971 to that Law.

*According to the built-up area* are taxed:
a. family houses, of which at least a part is used by the owner or his close relatives;
b. dwelling houses with flats in personal ownership;
c. recreation chalets;
d. independent, not-rented garages.

The tax *rate* is fixed within margins scaled according to the size of the community in which the building is situated, in five groups. In principle the tax is computed along the bottom limit of the rate but a higher rate up to the top limit may be used by the National Committee, if the building is multi-storeyed, exceptionally well appointed or partly let to a third party. In respect of dwelling houses with flats in personal ownership the tax is always assessed along the bottom limit of the respective rate.

*Taxed according to rent and price of user* are all other buildings not assessed according to the built-up area, such as private dwelling and production buildings, rented houses, family houses left completely in the use of third parties, and leased independent garages. The price of user is identical with the rent payable if the flat were let.

From the rent and price of user are deducted some items, if these are included in the rent and price of user avowed.
Allowed as deductions are:
— payment for water supply and sewerage use;
— payment for central or remote heating and for warm water supplies;
— payment for garbage collection;
— expenses connected with the performance of the caretakers' work and remuneration for such work, except the price for the use of the caretaker's flat and possible refunds for the caretaker's accommodation.

*The rate* of the tax is progressive. On an assessment basis not exceeding 6,000 Kcs a year the rate is 45 percent a year, on a higher basis 50 percent. Taxpayers whose house tax assessment basis without the price of user exceeds the sum of 3,000 Kcs a year are liable to deposit the rent into a special repairs account with the State savings bank.

## IV. LEGAL REGULATIONS OF FEES

Fees are divided into two groups — State fees and local fees. The yield of the State fees goes to the State Budgets of the Federation or of the Republics, the yield of the local fees to the budgets of the National Committees. Classed as *State fees* are administrative fees, notarial, court and arbitration fees. Among local fees are spa cure taxes, apartment and dog charges as *compulsory fees* which the National Committee are liable to levy, and further charges for the use of public space, charges on admission fees and local resident taxes which are *optional fees*.

### A. State fees

1. *Administrative (official) fees*

Administrative fees are governed by the Administrative Fees Act. 24

*Taxpayers* of the administrative fees are citizens and organisations, unless they are exempt. The fee is paid by the person who instigated proceedings or in the instance of ex officio proceedings or in the interest of the party to the proceedings by the person in whose interest or in whose matter proceedings are carried out.

*Exempt* under the law are, for instance, budgetary organisations, State institutes, State funds, diplomatic and consular representatives of foreign countries, etc. In addition to such personal exemption, there are a number of impersonal exemptions, such as proceedings necessary to implement health insurance, social security, defense and other regulations.

*The object* of administrative fees and their *rates* is set down by the Ministry of Finance. Unless determined by a fixed amount, the price of the proceedings object is the basis of fee assessment. Tariff I lists fees assessed and collected by administrative authorities (e.g. for official certification, citizenship certificates, game licence, etc.), Tariff II fees assessed and collected by the State measures service.

2. *Notarial fees*

Notarial fees are collected for State notarial proceedings in respect of transfer of immovables for a consideration, for gratuitous property acquisition by death or transfer, pursuant to the Notarial Fees Act. 25

*Payer of the notarial fee for proceedings* is the person who made the application for notarial proceedings or, if the notarial proceedings are carried out without application, the person in whose interest the notarial proceedings were undertaken. Fees for proceedings connected with registrations of contracts are always payable by the transferee for the registration of the immovable transfer contract, the assignee of the right of personal land use contract for the registration of the establishment of such right and the owner of the immovable for registration of the contract of an immovable transfer restriction. *Exempt* from notarial proceedings fees are the Czechoslovak State, budgetary and contributory organisations and State funds as well as proceedings concerning transfer of property to socialist organisations.

*The rate and object* are set down in the Tariff by fixed sums or by percentage from the proceedings object.

*Notarial fees on the transfer of immovables* are paid on transfers for a consideration or on immovable property transfers from personal or private ownership to the ownership of other citizens; The basis is the payment for the immovable transferred. Particular provisions apply to the exchanges of immovables, in which case only one fee is payable. If an immovable is acquired from socialist ownership or transferred to socialist ownership no fees are levied. Payer is the transferor, payment is guaranteed by the transferee. In the instance of the acquisition of property sold under court ruling or by expropriation payer is the acquirer. In the case of exchange of immovables the transferor and transferee

24. Law No. 105/1951 as amended by Decrees No. 138/1960 and No. 162/1976.
25. Law No. 24/1964 and Regulatory Decree to that law No. 25/1964 (as amended by Decree No. 30/1972).

pay jointly and severally. The fee *rate* is progressive and divided depending on family relationship in privileged (1 to 5 percent) and common rate (other persons — 6 - 13 percent).

*The inheritance notarial fee* can be considered a regular inheritance tax and as such it can be compared with inheritance taxes levied in other countries. It is levied on the acquisition of property by inheritance and other gratuitous property acquisition owing to a citizen's death. The fee is also collected for gratuitous acquisition of property transferred to the heir by the deceased in the last three months before his death. *The fee is paid* by the acquirer.

*Assessment basis* is the price of the portion after deduction of debts and other liabilities. *Exempt* are, for instance, socialist organisations, deposits on registered bank savings accounts, movable assets not exceeding a sum of Kcs 3,000, the deceased' claims for social security and health insurance benefits, etc. For purposes of the determination of the applicable tax rate, taxpayers are divided into three groups, dependent on the degree of family relationship. Recipients of the first group are close relatives, i.e. spouse, natural children, parents, and other relatives in the direct line. The rates in this category range from 5 to 25 percent, the latter in the case of receipt of more than 300,000 Kcs. Recipients of the second group are other relatives, e.g. brothers and sisters, parents-in-law, etc. Applicable tax rates vary from 12 to 30 percent.
Other recipients are taxed in accordance with the tax table which applies to the third group. In this case, tax rates range from 20 to 55 percent.

*The donation notarial* fee can be compared with gift taxes in other countries and is collected for gratuitous property acquisition based on a legal act inter vivos. It is not levied on movable property worth less than 3,000 Kcs and on property acquired from socialist ownership or put into socialist ownership. Its *assessment basis* is the price of the property after deduction of debts and other liabilities and any possible consideration. *The fee is paid* by the acquirer, *the rate* is the same as in the instance of the inheritance notarial fee.

### 3. *Court fees*

Court fees are collected for the work of courts in civil proceedings, for court administration proceedings and for some prosecution proceedings; the fees are governed by the Court Fees Act. [26]

A single fee is payable for the entire proceedings in one instance.

*The object and rates* are set down by fixed amounts or by percentage of the price of the objects of the proceedings in the Annex to the Act. *Their assessment basis* is the price of the object of the proceedings, unless they are laid down by a fixed sum. *The fee is paid* as a rule by the person who instigated the proceedings, i.e. by the petitioner. But the Act provides a number of personal (e.g. budgetary organisations, soldiers doing national service, etc.) as well as material (e.g. court proceedings in matters of care of children under age and adoption, health insurance, social security, etc.) *exemptions.* In addition, on the basis of court decision exemption from court fees may be granted on application to proceeding parties who prove that payment of the fees would endanger their maintenance or the maintenance of their dependents.

### 4. *Arbitration fees* [27]

Arbitration fees are paid for proceedings by the State arbitration authorities.
Subject to arbitration fees are:
- suits for conclusions, changes or cancellations of economic contracts;
- property suits for economic contract performance;
- suits for basic delivery terms.

*Payer* is the party on whose instigation the arbitration proceedings were opened or the party who made a claim in the statement to the application for arbitration filed against him. On opening proceedings without application the arbitration authority will decide which party is liable to pay the fee. In pre-contractual suits, in suits for changes and cancellation of contracts, in property suits the object of which cannot be assessed and in suits for basic delivery terms a fixed *rate* of 500 and 1,200 Kcs, respectively, is applicable; in all other property suits the 2 percent linear rate. *Assessment basis* is then the value of the matter at issue.

## B. Local fees

Local fees, compulsory and optional, are governed by the Local Fees Act, [28] by the Local Fees on Apartments Decree, [29] by the Spa Cure Tax Decree, [30] by the Local Fees Decree [31] and by the Local Fee on Dog Keeping Decree. [32]

*The local fee on apartments* has been levied since October 1, 1964 (it was otherwise included in the rent as increment for the use of apartments), only on the excess area of apartments rented in houses in personal ownership, from apartments in apartment houses in private ownership and if apartments are used for other than living purposes.

*The fee is paid* by the apartment user monthly into the budget of the National Committee. Its *assessment basis* is the total area of the living rooms exceeding the area to which the apartment user is entitled; in the instance of apartments serving other than living purposes the entire floor area is subject to the fee. *The rate* is fixed, scaled in accordance with the area expressed in square metres.

*The local fee on keeping dogs* is paid by persons keeping dogs older than six months. The purpose of the fee is to provide a basis for the registration of dogs, the regulation of their numbers and to safeguard the interest of the State in breeding only some working races. On application made in time National Committees and other

26. Law No. 116/1966.
27. Levied on the basis of a Decree of the Minister of Finance No. 78/1958.
28. Law No. 82/1952.
29. Decree No. 112/1957.
30. Decree No. 71/1964.
31. Decree No. 67/1966.
32. Decree No. 36/1972.

budgetary organisations, Svazarm, gamekeeping associations, the Czechoslovak Red Cross, blind and disabled persons, the staff of forestry and agricultural enterprises, members of the armed forces, breeders breeding dogs for scientific purposes, zoological gardens and persons enjoying diplomatic privileges are *exempt* from the fee on keeping dogs.

*The rate* of the fee is fixed — 120 Kcs, with the exeption of large cities where the basic rate amounts to 400 Kcs, and this may, in view of the population number, be reduced or increased by the National Committees up to 1,000 Kcs for one dog and 1,500 Kcs for a second and any additional dog.

*The Spa Cure tax* is collected from persons staying temporarily in a "Spa" town in the main season from May 1 to September 30. Outside the main season it is collected only if the National Committee so decides. Its purpose is to contribute to cover the expenditure connected with the use of the spa facilities and services. The fee is collected by the person providing accommodation, who remits it to the competent National Committee at *the rate* of 1 to 4 Kcs per day depending on the "Spa" category. *Exempt* from the fee are the majority of patients taking a cure in the "Spa", companions of blind and sick persons, persons staying temporarily in a "Spa" town for the purpose of studies or of performance of their profession, cognates of persons living permanently in the "Spa", children under the age of 15, participants in children's recreation and school trips, participants in the ROH Foreign Exchange Recreation, and participants in special training outside the main season.

*Fee for the use of public space* like the local resident tax and the charge on admission fees is optional. *It is levied* on organisations and citizens for the use of public space (streets, squares, market places), for building, advertising, to set up circuses and other entertainment facilities, stalls, permanent car parks and for dumps of any kind. Applicable is the skeleton *rate* of 4 Kcs per square metre. The actual rate shall be fixed, depending on local conditions, by the National Committee, which is entitled to increase the rate up to twice as much, if the term of use of a public space is not kept.

*The local resident tax is levied* for the National Committee by the person providing accommodation in recreation and holiday centres. Such centres are designated by the District National Committee in agreement with the District Trade Union Council. *The rate* is again fixed only at its top limit, 2 Kcs per person and day, with the proviso that *the tax is not paid* by owners of immovables subject to house tax, cognates and brothers and sisters of the person providing accommodation, their husbands and wives, persons staying in such places for the purpose of performance of their profession or studies, children under the age of 15 and participants in children's recreation, school trips, training, etc.

*The charge on admission fees* is collected from citizens, organisations and associations of persons on admission fees to performances of primarily an entertaining and commercial nature, such as dances, variety shows, etc., dancing courses being exempt. It is levied in communities where the National Committee in agreement with the District Trade Union Council decides that it should be collected.
*The rate* is either linear up to 30 percent of the total of actually collected admission fees, the National Committee being entitled to reduce the rate, or it is fixed by lump sum depending on the capacity of the hall.

*Customs duty regulations*

Until recently, customs relations were regulated by the Customs Duty Act [33] with implementing regulations.[34]

The regulation was tributary to the time it came into being. Imports, exports and transit of goods in the fifties were effected through foreign trade.

33. Law No. 36/1953.

34. Particularly Decree No. 82/1961, issued by the Ministry of Foreign Trade.

32nd International Congress of IFA (Sydney)

# FISCAL POLICY AND TAX STRUCTURES IN THE PACIFIC AND INDIAN REGIONS

On September 20, 1978 during the IFA Congress to be held in Sydney a special seminar will be devoted to the tax structures of countries in the Pacific Region and neighbouring areas and the fiscal policy followed by their Governments. This Seminar which will be chaired by Mr. S. Ambalavaner from Sri Lanka (Ceylon) has been largely coordinated by himself and Professor J. van Hoorn Jr., Managing Director of the International Bureau of Fiscal Documentation.

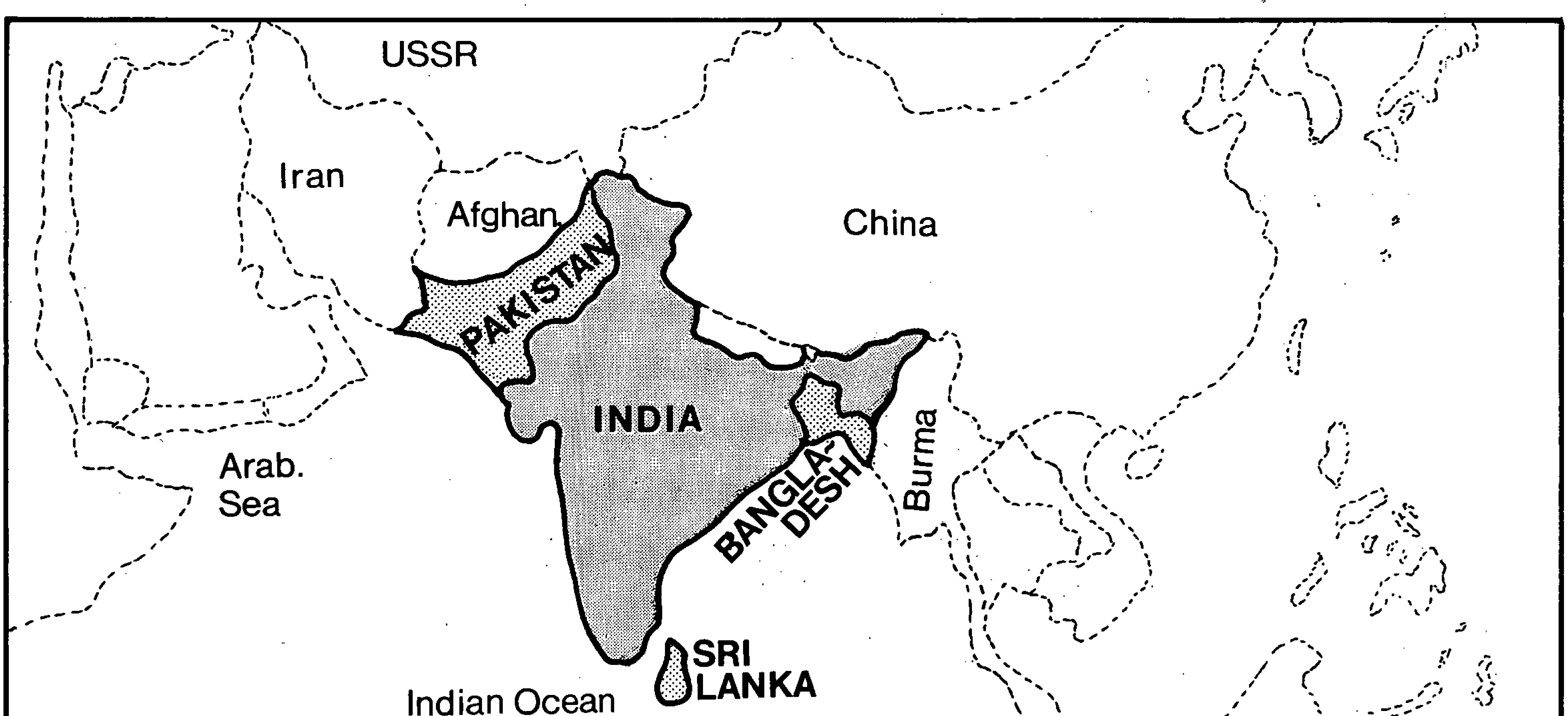
The Editors of the *Bulletin* are proud to be able to publish papers dealing with the subject of fiscal policy in 12 countries situated in the Pacific and Indian regions.

The first group of papers appeared in the June issue and comprised a number of Asian countries which are either highly developed, such as Hong Kong, Japan and Singapore, or which have reached a certain degree of development, such as South Korea.

The second group of papers, published in this issue of the *Bulletin*, focusses on developing countries in the Indian region and will discuss Bangladesh, India, Pakistan and Sri Lanka.

The third group of paper will — in honour of the 32nd Congress of IFA in Sydney — deal with Australia and countries in the neighbourhood of Australia, i.e. Indonedia, Philippines and Western Samoa. This group will appear in the August issue.

A sufficient number of reprints of these papers will be available at the Sydney Congress for free distribution to the participants.



# BANGLADESH:
# Tax Structure and Fiscal Policy

by K.A. Dewan*

## I. INTRODUCTION

Bangladesh, as we know, is a newly born country, carved out of Pakistan and is a country with a decidedly poor economy. In the same way as other developing countries of the world, however, she has been trying to come to grips with her poverty and ensure genuine economic development without endangering economic stability. All the policies of the Government of Bangladesh are actually geared to this end. We are perhaps not out of place if we state that the fiscal policy of the country is no exception in this respect. The fiscal policy of Bangladesh, keeping in mind its developmental obligations, primarily aims at two things.

(i) Mobilisation of resources draws its primary attention. The emphasis here is clearly reasonable in so far as this does directly contribute to the capital formation in the country, when and where such resources are utilized for developmental purposes through state participation. One would, however, be failing in his duty if one did not acknowledge that in achieving the aim itself due consideration is given to the equity side of the problem.

(ii) The second major thing which the fiscal policy of Bangladesh tries to achieve is to ensure a favourable climate where private efforts at resource mobilisation and resource utilisation leading to investment for development are facilitated. Individuals from both home and abroad are encouraged in this regard with particular reference to the industrial sector within the broad framework of our industrial policy which has its own preferences and restrictions. The same is true about foreign participation at official level. The following detailed discussion of our fiscal policy will substantiate the propositions.

## II. TAX STRUCTURE

*Sales tax* which is a good source of revenue is levied at the standard rate of 20 percent of the value of merchandise sold. Essential goods are exempted. Some items are taxed at concessional rates and luxury items are taxed at a higher rate than the standard rate. Exports other than raw hides are exempt from payment of tax.

The standard rate of tax is 20 percent, the minimum rate of tax is 5 percent and the maximum rate is 30 percent. Total collection for the year 1976-77 amounts to Taka 1,253 million which constitutes 17.26 percent of gross revenue earnings.

### Income tax

Tax liability is determined on the basis of residence. An assessee who is "resident and ordinarily resident", irrespective of nationality, has to pay tax on the basis of total world wide income. The same principle is applicable to the person who is "resident but not ordinarily resident" except that the income, profits and gains which accrues or arise to him outside Bangladesh shall not be included in his total income unless they are derived from a business controlled in or a profession or vocation exercised in Bangladesh or unless they are brought into or received in Bangladesh during such year. A non resident will pay tax on the basis of income which accrues or arises or is received in Bangladesh. Income tax in Bangladesh is charged on the person and such person includes an individual, a Hindu undivided family, a firm, an association of persons, a body of individuals, whether incorporated or not, a company, a local authority and any other artificial juridical person. Different conditions are prescribed in the Act (vide Section 4A and 4B) for determining the residential status of these various persons.

The rate of tax (except for corporate bodies) is progressive. The minimum rate is 7½ percent and the maximum is 65 percent. However, no tax is chargeable on total income which does not exceed Taka 9,000. In the case of a company, the rate is a flat 30 percent of the income (other than bonus, bonus shares, and intercorporate dividends on which no income tax is due). A company has also to pay super tax at the rate of 25 percent of the income (other than bonus, bonus shares, and intercorporate dividends where super tax ranging from 15 to 20 percent is charged depending upon whether the company is public or private). It should be mentioned in this connection that in order to encourage the formation of smaller companies, a total exemption from super tax up to Taka 150,000 is given, i.e. no super tax is payable by a company on its income up to Taka 150,000.

As an incentive for attracting both local and foreign capital, a tax holiday of 5 years in more developed areas and 9 years in less developed areas is given. An export rebate varying from 30 to 50 percent is allowed to all assessees except those companies which are not registered in Bangladesh.

The total collection during the year 1976-77 was Taka 1140 million which constituted 15.74 percent of total revenue.

### Wealth tax

Wealth tax is levied on individuals and Hindu undivided families. Corporate bodies are exempt. Wealth below Taka 500,000 is not taxed. The rate of tax is progressive, the lowest rate being ½ percent and the highest 2½ percent of total wealth.

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* Member (Taxes), National Board of Revenue.

The total collection during the year 1976-77 was negligible compared to total revenue.

### Gift tax

Gifts exceeding the value of Taka 5,000 are liable to tax. In the case of the spouse the exemption limit is Taka 50,000. Gifts to charitable institutions or to the Government are free. The rate of tax is progressive. The lowest rate is 5 percent and the highest 30 percent.

### Estate duty

Estate duty is levied on the principal value of the property left by the deceased exceeding Taka 200,000. The rate of tax is progressive. The minimum rate is 5 percent and the maximum 50 percent.

### Excise duty

Excise duty can be imposed by the Government on any commodity produced in the country other than narcotics and alcoholic beverages, which are taxed separately. Unlike the sales tax, which is leviable on all goods, excise duties are imposed on a selective basis. The duty is levied at specific or ad valorem rates keeping in view the nature of the commodity and the convenience of the taxpayer and tax-collector.

The substantive Excise Laws are contained in the erstwhile Central Excise and Salt Act 1944 as adopted in Bangladesh. The procedural Excise Laws are contained in the rules promulgated by the National Board of Revenue under the rule-making powers conferred by the Act. The rules relating to the Ordinary Excise procedures and the self-assessment and self-clearance procedure are contained in the erstwhile Central Excise Rules 1944, as adopted in Bangladesh.

The total collection during the year 1976-77 amount to Taka 2,077 million which constituted 28.63 percent of total revenue.

### Customs duty

Custom duties are levied under the Tariff Act, 1934. The rates of import duties are indicated in the First Schedule of the Tariff Act which is commonly known as B.C.T. The import Schedule is divided into twenty-one sections and ninety-nine chapters each section and chapter containing broadly similar goods. The Scheme of B.C.T. is based on the Brussels Nomenclature which was adopted in Pakistan in 1960 and which continues to apply in Bangladesh. With the exception of a few items like tea, tobacco, cloth, sugar, alcoholic liquor etc. almost the entire tariff consists of ad valorem rates of duty.

The total collection under this head during the year 1976-77 amounted to Taka 2,776 million which constituted 38.26 percent of total revenue.

## III. ORIENTATION OF FISCAL POLICY: TAXES ON "INCOME, PROFITS OR GAIN", WEALTH, ESTATES, AND GIFTS

A number of economic measures have been taken by the Government for rapid industrialisation and capital formation in the country. To attain the objectives in view, provisions have been made in the Income Tax Act to attract capital for economic growth of industries and capital formation. These incentives are in the form of tax holidays for new industrial undertakings for a period of five years in more developed areas and nine years in less developed areas. This facility is available both to foreign and local capital provided that it is used for industrial undertakings (assessees) which either re-invest 60 percent of profits in the same industry or in the purchase of Government bonds (vide Section 14A).

It has, however, been found that most of the countries which have at an earlier date adopted a tax holiday scheme have either subsequently abandoned it or provided alternative incentives, because this scheme has not been found to provide an adequate incentive for rapid industrialisation. Also it has not helped the dispersal of industries as was expected. Particularly in the case of foreign investors it has not provided any real incentive because in the absence of any "matching credit" in the investors' country the foreign investors do not get any benefit of tax concession in their home countries. An alternative incentive has, therefore, been provided to those industries which were set up between July 1, 1977 and June 30, 1982. On the fulfillment of specified conditions these industries whether established in developed or less developed areas will be entitled to accelerated depreciation of 80 or 100 percent respectively in the first year [vide section 10(2)(vib)]. In addition, the newly set up industries in the aforesaid areas will get an investment allowance of 20 percent and 25 percent respectively of the cost of machinery and plant. These two incentives would be available as an alternative to the tax holiday. In order to attract foreign capital it has also been decided to exempt interest on certain specified categories of foreign loans which are indicated below:

(a) By the Government or local authority.
(b) By any industrial undertaking for purchase of plant.
(c) By a statutory financial institution or bank for advancing loans to industrial undertakings for purchase of machinery and certain approved goods and
(d) By the Bangladesh Biman and Shipping Corporation for the purchase of aircraft and ships.

Twenty percent of the total income or Taka 12,000 (whichever is lower) is exempt from tax payable by an assessee, not being a company, invested in the purchase of shares of approved new industrial undertakings (vide section 15C of the I.T. Act).

Provisions have also been made to exempt a portion of income or profit of an assessee, not being a company, from taxation, if it is spent in the purchase of Post Office Savings Certificates and Union Trust Certificates issued by the National Investment Trust (vide section 15AA).

No tax is payable by an assessee, not being a company, on so much of his total income as is invested by him in the purchase of debenture stock issued by a company. The maximum exemption of income that is available for investment under section 15AA, 15C, 15CC is governed by the provisions of sub-section 3 of section 15. The total exemption is restricted to 30 percent of the total income or Taka 20,000 whichever is lower.

An initial depreciation of 25 percent of the cost is allowed over and above the normal depreciation in respect of any plant or machinery newly erected or used for the first time in Bangladesh (vide section 10(2)(vi). And in the case of factory buildings and residential buildings for industrial workers this depreciation is allowed at the rates of 15 percent and 25 percent respectively.

Any expenditure, whether of an income or capital nature, expended on scientific research related to the business is eligible for immediate deduction in the computation of total income (vide 10(2)xiii and xiv).

Any expenditure incurred for the training of the citizens of Bangladesh in connection with a scheme approved by the National Board of Revenue ranks for immediate deduction in the computation of total income (vide section 10(2)xv).

There is a great demand for technical know-how in Bangladesh. To attract foreign experts in the industrialisation of the country, tax concessions have been provided for a period of three years in respect of the salaries of foreign technicians who did not serve in Bangladesh previously. These concessions are not available to local technicians (vide section 4(3)xiii). And even after that period of 3 years no tax on tax is charged for five years on the income of foreign technicians if the tax is paid by the employer (vide section 4(3)(xiiia). The salary of a foreign professor is also exempt for two years (vide section 4(3)(xiv).

An attractive incentive has also been provided for construction of residential buildings to ease the problem of housing in the cities. The income of residential buildings the construction of which is begun and completed at any time between July 1, 1975 and June 30, 1980 is exempt from payment of tax for 5 years provided, however, the plinth area does not exceed 2,000 sq.ft. (vide section 4(3)xiig).

This tax exemption for five years is also available to housing companies, societies or estates where the construction comprises bungalows, flats, apartments or units each containing a plinth area of not more than two thousand square feet, provided that not less than twenty-five units are constructed.

Prior to the assessment year 1977-78 a company was liable to pay income tax at the rate of 30 percent and super tax at the rate of 30 percent irrespective of the quantum of income. This, however, does not include "deemed" income such as bonus or bonus shares and intercorporate dividends. From the assessment year 1977-78 a company is exempt from super tax on the first Taka 150,000 of its total income (other than bonus, bonus shares and intercorporate dividends). The rate of super tax has been reduced from 30 to 25 percent. A rebate of 5 percent of super tax is allowed to Public Companies which have made such satisfactory arrangements as may be prescribed by the National Board of Revenue for the declaration and payment in Bangladesh of dividends payable out of such profits and gains and for the deduction of tax from such dividends.

To encourage the export of industrial goods a rebate of tax ranging from 30 to 50 percent of the income tax and super tax, if any, is allowed with reference to the quantum of the export sale.

An exporter who is not a manufacturer is also entitled to an export rebate of maximum 30 percent of the profit attributable to export sales.

The mechanism of income tax has been applied for curbing the inflationary trend of the economy by providing for advance payment of tax. This advance payment is due in four equal instalments in respect of income which is subject to tax in the year subsequent to its accrual or receipt, if it exceeded Taka 20,000. As a result, an assessee makes future payment of tax in the year of account in which he earns it. This is intended to restrict unnecessary expenditure which creates conditions favourable to inflation (vide section 18A).

Due to a huge amount of construction work in various fields a great number of contractors are earning profits from contract work or from rendering various services. To prevent inflation and also to prevent tax evasion, provision has been made to deduct at source a certain percentage of billed amounts as tax. The amount so deducted may be credited at the time of assessement. This provision applies only in the case of payments made by the Government, statutory corporations and local authorities to avoid fraud.

Bangladesh offers a number of incentives to foreign investors, such as:

1) Repatriation of capital and capital gains out of the sale of assets.
2) Remittance of all taxed profits from foreign capital.
3) Remittance of approved royalties and technical fees.
4) Tariff protection for qualifying industries.

Both foreign and local investments are welcome in all industries except the following:

1) Arms and ammunition and allied defence equipment.
2) Atomic energy.
3) Jute industry.
4) Textiles (excluding handlooms and specialised textiles).
5) Sugar.
6) Air transport.
7) Telephone, telephone cables, telegraph and wireless apparatus (excluding radio receiving sets).
8) Generation and distribution of electricity.

### Wealth tax

In order to discourage undue accumulation of wealth in a few hands without hindering the growth of the economy of the country, wealth tax and estate duty were introduced.

The maximum net wealth which is not liable to payment of Wealth tax is Taka 500,000. The rate of tax on the first slab is ½ percent of net wealth. The maximum rate of tax is 2½ percent if the net wealth exceeds Taka 2,300,000.

### Estate duty

Estate duty is not levied if the net wealth of the estate left by the deceased does not exceed Taka 200,000. The minimum rate of tax is 5 percent and the maximum is 50 percent, if the value of the estate exceeds Taka 5 million.

Gift tax is levied to curb the tendency of taxpayers to transfer their sources of income to dependents, relatives or to persons who are obliged to carry out the orders of the assessee.

The first and foremost objective of taxation is to provide revenue to government. In recent years taxation has been used increasingly for the regulation, control and direction of the national economy. More specifically, tax policy has been used to accomplish objectives such as:

1) Restraining consumption and increasing the rates of saving and investment by providing appropriate incentives;
2) Achieving the desired pattern of investment and development;
3) Encouraging domestic production by an appropriate tariff policy;
4) Regulating imports to improve the balance-of-payments situation;
5) Promoting exports through tax rebates;
6) Dispersal of industry through tax holidays and alternative incentives in the form of accelerated depreciation and investment allowance;
7) Diversification of industries by giving tax concessions to selected industries;
8) Control of inflationary pressures by mopping up excess purchasing power;
9) Encouraging the ploughing back or distribution of profits by companies through appropriate policies according to the requirements of the economy;
10) Promoting equitable distribution of income and wealth.

## IV. ORIENTATION OF FISCAL POLICY: SALES TAX, EXCISE DUTY AND CUSTOMS DUTY

### Sales tax

Sales tax is levied on the value of goods produced in Bangladesh, on the importation of goods from abroad and in certain limited cases on export, on the basis of the Sales Tax Act, 1951, adopted in Bangladesh with some modifications. The standard rate of tax is 20 percent (vide section 3(2)).

For the purpose of the imposition of Sales tax, goods have been classified into different categories. Certain goods are exempt from tax on importation, while other goods are exempt only if they are produced in Bangladesh.

Some goods are taxed at reduced rates, while luxury goods are taxed at rates which are higher than the standard rate.

The Act authorises the Government to apply its discretionary powers of varying the rate of tax on goods when it is found suitable in the public interest (vide section 7 of the Act).

Proviso I of Sub-section 2 of Section 3 authorises the National Board of Revenue to notify the enhanced rate of tax for the goods annexed in the Schedule of the Act.

It can be seen from the Schedule that the only goods placed on it are luxury goods meant for the wealthy section of the country or goods which impair the morality of the consumers.

From the list of the goods on which tax is charged at reduced rates (table annexed to the Act and the rule) it will appear that only these goods which are generally used for the construction of buildings or those goods for whose supply the country is dependent on other countries have been placed in that list so as to keep the price of the goods within the purchasing capacity of the common consumer. Goods like asbestos sheets, pig iron, billets, imported coal, G.I. wire, nailwire and screw wire etc. have been selected for concessional rates of taxes. Essential goods like cereals, or goods commonly used by the poorer section of the country are totally exempted from payment of sales tax. A list of such goods is to be found in the annexure to the Act and the rule.

Machinery or machinery parts intended for the utilisation for the first time in a new industry are also exempt from payment of tax. The main purpose of the exemption is twofold: firstly to keep the cost of capital goods as low as is possible and secondly, if the cost goes up the industrialist will distribute the cost in determining the price of the products. As a matter of fact, foreign or local entrepreneurs are encouraged to come forward to invest in industries which may yield a fair rate of profit from their investment while keeping the cost of construction lower.

Bangladesh is mainly dependent on agriculture, having insufficient industrial activities of its own. Thus one of the main policies is to generate more economic activities in all directions in order to provide employment to the growing population. It is by the diversification of activities within the country that this objective can be obtained. To encourage more production all exports except poultry and poultry products and raw hides and skin have been exempted from the payment of tax. As a result of this concession, goods produced in Bangladesh can be made available in foreign countries at a comparatively low price. Consequently, the demand for these goods may increase substantially which will ultimately generate more employment for the growing population.

Sales tax is normally charged either on the finished goods or at the raw materials stage. However, in respect of a few goods no sales tax is charged at all — either on the finished goods or on the raw materials (section 4 of the Act).

The general scheme of a single point taxation has been effected by the system of allowing a credit to a licensed manufacturer of the amount of tax paid at the time of import or local purchase of goods if such goods are partly manufactured goods and are actually used in the manufacture of goods which are subject to tax.

Goods produced by cottage industries are exempt from payment of tax except goods manufactured by gold and silversmiths within Bangladesh.

It will appear from the above discussion that besides ensuring distribution of income, sales tax provides an incentive for rapid industrialisation by allowing an exemption from payment of sales tax for machinery intended for newly established industries. Exports are exempt from payment of sales tax. This is another way of encouraging production of goods thereby creating more job opportunities.

### Customs duty

Special facilities are also provided for in the Customs Duty Act as an incentive for investment in industry. These are:

1) Import duty on imported capital machinery is 2½ percent ad valorem for less developed areas.
2) The import duty on spare parts is levied at half of the existing rate which was in force before March 1, 1977 for a period of five years, for less developed areas.

### Excise duty

Excise duties are levied on a selective basis excluding the essentials of daily life.

## V. ORIENTATION OF FISCAL POLICY: OTHER (NON-TAX) FIELDS

1) Subsidies previously allowed on jute or other goods for export have been withdrawn. Now there is no subsidy for any goods.
2) To encourage investment in industry in less developed areas there is provision for preferential treatment in respect of equity financing from the Bangladesh Shilpa Bank and Investment Corporation of Bangladesh.
3) The interest rate will not exceed 11½ percent on loans to industries in less developed areas.
4) Electricity is available to selected industries at a preferential rate in the less developed areas of the country.
5) The pool price of petroleum is strictly enforced so that the cost of running industries does not go up in the form of payment of higher price for essential consumables produced by industries in less developed areas.

In addition to several other facilities for investment in industries financial assistance and equity participation are available from a number of national and international institutions in local as well as foreign currency.

The Bangladesh Shilpa Rin Sangstha is a leading development financing institution in the country. This bank provides financial assistance both to the public and private sectors of industry. The major function of this Bank includes the provision of medium and long term credit facilities in both foreign and local currencies. It also helps prospective investors in the identification of projects and formulation of project proposals. It also provides for underwriting/bridge-financing/debenture finance assistance to public limited companies in association with the Investment Corporation of Bangladesh.

It gives advice to prospective private investors.

### Bangladesh Shilpa Bank

This is an institution which provides loans to industries both in foreign exchange and local currencies.

The Bangladesh Small and Cottage Industries Corporation has already set up 18 industrial estates all over the country. It provides loans to private entrepreneurs. It mainly promotes cottage industries and small industries in the country with capital not exceeding 1 million Taka.

### Investment Corporation of Bangladesh

This institution was established (1) to encourage and broaden the base of investment, (ii) to develop the capital market and (iii) to mobilise saving. It underwrites the public issue of shares and provides bridging loans. It purchases corporate debentures and bonds. It participates in dis-investment programme. It also participates in joint venture/collaboration projects and acts as a counsellor to investors.

The International Finance Corporation which is an affiliate of the International Bank for Reconstruction and Development has also taken up a few projects for financing.

As a matter of fact there is vigorous activity in the country to make up the deficiency in development work resulting from past neglect in almost every sphere of life, both in urban or in rural areas. As a natural corollary to development activities there is a tendency for inflation and consequent price rises in consumer goods. To counteract this effect, the Government has taken a number of measures to divert money from the market for investment and development purposes by the issue of securities and by providing a high rate of interest for small savings.

The Bangladesh Trading Corporation has been established for the import of consumer goods from abroad for sale to consumers at reasonable prices in competition with private businessmen.

To avoid inflation in development work, rural development work is now mostly done on the basis of payment in kind. Labourers are paid their wages in terms of rice and wheat. This has effectively checked inflation. Now the aim of the Government is to generate activities in rural areas where 80 percent of the population live without having any work for six months in the year.

Bangladesh, although a very fertile land because of its many rivers and canals, cannot yet meet the entire demand for food of the country. This food deficit is due partly to old methods of cultivation and partly to its large population. The Government, in order to increase food production, has provided some incentives for growing more food by intensive and extensive cultivation. The change-over to modern methods of cultivation is being effected gradually. The Government has also launched a family planning campaign to check the population growth vigorously.

An agriculturist having less than 10 bighas of agricultural land is exempt from payment of land tax. Khasland possessed by the Government is being distributed to genuine cultivators. It has been the avowed policy of the Government not to keep any cultivable land fallow.

Co-operative societies dealing in agricultural produce for their members or the income from buildings owned by such a society for storing the products of their members are also exempt from payment of income tax.

Fertilizers are sold at subsidised rates. A great stride has now been made in the production of food by the aforesaid policy of the Government.

Nationals of Bangladesh working abroad are allowed to remit their earnings in pounds sterling or dollars for sale on the open market. These are in great demand for import purposes.

Import of goods under the wage earners' scheme is also successful in curbing the tendency to rising price levels of capital or consumer goods. Under this scheme, nationals of Bangladesh working abroad are allowed to send foreign goods against their earnings for sale in Bangladesh. This being advantageous for the wage earners, most of them take this opportunity of earning profits from the sale of goods so imported in the country. This has actually helped in lowering the price of goods. Import of goods under the wage earners' scheme has also helped in saving valuable foreign exchange for the Government.

# INDIA:
# Tax Structure and Fiscal Policy

by M.C. Bhatt*

## I. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, ESTATE AND GIFTS

The Fiscal policy, as far as direct taxes are concerned, is designed to increase corporate savings, channel more funds into productive investment, accelerate the pace of industrial growth, promote scientific and technological self-reliance, stimulate setting up of small scale industrial undertakings in rural areas, encourage companies to involve themselves in the work of rural welfare and uplift and simultaneously reduce economic disparity.

### 1. Catalogue of taxes imposed at the national level and their basic structure

1. *Names of taxes and acts*

Income-tax, Sur-tax, Interest-tax, Wealth-tax, Gift-tax and Estate-duty

Respective Acts:
Income-tax Act, 1961.
Companies (Profits) Sur-tax Act, 1964.
Interest-tax Act, 1974.
Wealth-tax Act, 1957.
Gift-Tax Act, 1958; and
Estate-duty Act, 1953.

2. *Minimum and maximum rate(s)*

| Name of tax | Minimum rate % | Maximum rate % | Remarks |
|---|---|---|---|
| Income-tax | 17.25 | 69 | Inclusive of surcharge @ 15% of tax. |
| Sur-tax | 25 | 40 | On chargeable profits over 15% of the capital on companies only. |
| Interest-tax | 7 | 7 | Levied on interest income of scheduled banks only. |
| Wealth-tax | 0.5 | 3.5 | Not levied on companies. |
| Gift-tax | 5 | 75 | — |
| Estate duty | 4 | 85 | — |

3. *Basis of tax on income*

— All persons, whether resident or non-resident, are liable to income-tax.
— Resident are taxed on world income.
— Non-residents are taxed generally on domestic income only.

4. *Total revenue – Percentage of total revenue and of GNP etc.*

The figures of GNP, national income, per capita income, total revenue, revenues from direct taxes forming part of total revenue, etc. for selected years are as follows:

| Year | GNP | National income | Per capita income | Total revenue | Direct taxes | Percentage of direct taxes to total income | Percentage of direct taxes to GNP |
|---|---|---|---|---|---|---|---|
| | (In crores [1] of rupees) | | | | | | |
| 1960-61 | 13999 | 13236 | 305.6 | 908.92 | 291.08 | 32.02 | 2.07 |
| 1965-66 | 21866 | 20637 | 425.5 | 2060.67 | 588.05 | 29.00 | 2.73 |
| 1970-71 | 36568 | 34462 | 637.0 | 3206.80 | 869.31 | 27.01 | 2.37 |
| 1975-76 | 64168 | 60293 | 1004.9 | 7608.78 | 2203.93 | 28.96 | 3.43 |
| 1977-78 | — | — | — | 8878.92 | 2418.25 | 27.24 | — |

### 2. Fiscal policy

a. *Investment (domestic and foreign)*

— Profits and gains from newly established industries or ships or hotel business are exempt from income-tax for five years up to 6 percent of the capital.
— In the case of a company deriving such profits and gains from industrial undertakings commencing manufacture or production after March 31, 1976 or from ship or hotel business started after that date, they are entitled to exemption equal to 7½ percent in place of 6 percent of the capital employed.
— 20 percent of profits and gains derived by a new industrial undertaking or hotel set up in specified backward areas are exempt from tax for 10 years from the establishment of the industry.
— 20 percent of profits derived by small-scale industrial undertakings set up in any rural area are

* Retired Joint Secretary, Ministry of Finance.
1. 1 crore = ten million.

also exempt from tax for 10 years beginning with the year in which the undertaking begins to manufacture or produce articles.

- Normal depreciation allowance on buildings, furniture, plant and machinery at prescribed rates are deducted in computing taxable income.
- In addition to normal depreciation allowance, investment allowance equal to 25 percent of the cost of new ships, aircraft, plant and machinery is granted.
- Plant and machinery installed for the manufacture of non-priority items, however, are not eligible for the investment allowance.
- Higher investment allowance equal to 35 percent of cost of plant and machinery is granted for users of indigenous technology.
- Expenses incurred on scientific research by the industry as well as contributions made by industry to approved scientific research institutions are deducted in full in computing taxable income.
- Weighted deduction equal to one and one third times is permitted for the sum paid for sponsored research.
- There is no tax on dividends received by a domestic company from another domestic company engaged in the manufacture or production of items like cement, paper, pesticides, inorganic and organic heavy chemicals, industrial explosives, electric motors, industrial and agricultural machinery, earth moving machinery, fertilisers, soda ash, caustic soda, commercial vehicles, ships.
- Intercorporate dividends in other cases are taxed partially, i.e. only 40 percent of such dividends are taxed.
- Dividend income of foreign companies is taxed at the rate of 25 percent.
- There is no tax on capital gains on assets transferred or sold (held for more than 36 months), if the entire consideration of the transfer is invested in new shares of Indian public companies, Government Securities, etc. or deposited in a bank for at least three years.
- Dividend income and income from other specified investments is exempt up to Rs 3,000 in the hands of an individual.
- Interest payable on moneys borrowed or a debt incurred by an Indian industrial undertaking in a foreign country for purchase of plant and machinery or raw material outside India is exempt from tax to the extent the rate of interest is approved by the Government.
- There is a five year "wealth-tax holiday" for initial equity share in industrial companies.
- Shareholdings in Indian companies and other investments are exempt from wealth tax up to Rs 150,000.

b. *Trade (domestic and foreign)*

- In the case of a non-resident, no income is deemed to accrue or arise in India to him through foreign operations which are confined to the purchase of goods in India for the purpose of export.
- Resident tax-payers are granted a weighted deduction equal to one and one third times the expenditure incurred for promoting exports. Domestic companies, however, are entitled to a weighted deduction equal to one and one half times the expenditure.

c. *Transfer of technology, know-how and managerial skills*

- Royalty and technical service fees received by foreign companies under approved agreements entered after March 31, 1976 are taxed at a flat rate of 40 percent of gross amount of royalty and technical service fees.
- Lump sum technical know-how fees paid to non-residents outside India under agreements approved after March 31, 1976 are taxed at 20 percent of the gross amount.
- Income by way of interest, technical service fees, and royalties received from Government or local authority or any Indian concern by a non-resident company is *not* liable to sur-tax.
- Remuneration up to Rs 4,000 per month of a foreign technician having specialised knowledge and experience in construction, manufacturing, mining, generation or distribution of electricity or other form of power, industrial and business management, etc. is exempt from tax for the first 24 months.
- An employer is free to pay higher remuneration and pay tax on the excess amount without imposing any tax liability on the technician. The contract of service is, however, required to be approved by Government.

d. *Diversification and selectivity*

- As to countries from which investment, technology, etc. is solicited:

Government policy does not discriminate as to countries for inviting investment and procuring technology. Domestic enterprises are allowed to import sophisticated technology developed in other countries, where Indian skills and technology are not adequately developed. A large number (approx. 4,000) of foreign collaboration agreements have been entered by Indian concerns with their counterparts in most of the developed countries, e.g. U.S.A., U.K., Germany, Japan, Switzerland, etc. The industrial development and technological skills in the country have now made considerable progress and attained a stage so as to enable it to export technology to other developing countries; several joint ventures have been set up abroad by Indian industrialists.

- As to types of areas of investment, trade, etc.:

The approach to foreign technical and financial collaboration is selective and flexible. This is based on the need of technology which is not sufficiently developed indigenously. The need to import technology is, however, reviewed from time to time, bearing in mind indigenous technological development.

- As to regional or special areas, including free trade zones (i.e. regions or areas of the country, particularly backward areas, to which investment should be directed):

Greater emphasis is now being laid on setting up industries in backward and rural areas by providing tax and other fiscal incentives and financial institutions and banks playing a positive promotional role. Free trade zones in backward areas are also set up; e.g. Kandla Free Trade Zone.

e. *Difference in treatment, if any, between the public and private sectors*

While there is no difference in the tax treatment of the incomes of public and private sector undertakings, certain industries of basic and strategic nature are reserved for the public sector only. Industries such as fertilisers, pesticides, steel, aluminium, transport, capital goods, etc. are open to both public and private sectors. About 500 items are listed and reserved for small scale sector undertakings. The decision to set up an industry in the public sector or in the private sector is based on various factors such as the quantum of investment, the area in which the investment is taking place, the category of industry, whether it is labour intensive or capital intensive, profitability of the unit and the like.

— Other direct taxes like wealth-tax, gift-tax and estate duty aim at redistributive justice and are not detrimental to domestic investment.
— During the last few years, the rates of income-tax on personal incomes have been reduced considerably. Taxation of capital gains has also been modified very recently with the sole objective of diverting unproductive assets into channels which directly or indirectly help production.

The fiscal and monetary policy is geared towards creating a favourable climate for foreign as well as domestic investment. Apart from giving general tax incentives for the establishment of new industries, specific tax incentives are also given for diverting investment into desired specific areas.

Moreover, the rigours of taxation are also removed by giving double taxation relief. India has entered into double taxation avoidance agreements with a number of countries. In case no such agreement exists, relief is given unilaterally under the Indian tax laws. The tax policy is based, by and large, on the principle of capacity to pay and simultaneously to bring about an egalitarian society. The policy is also aimed at stimulating national growth, encouraging production and savings.

## II. ORIENTATION OF FISCAL POLICY, SALES TAX, EXCISE DUTY, CUSTOMS

Important in this respect are:

(i) re-distribution of wealth
(ii) employment
(iii) regional development

Apart from raising resources, the mechanism of central excise and custom duties is used to implement the socio-economic policies of Government. Fiscal reliefs are given on a selective basis and are not given as a matter of rule. Excise duty concessions to the small-scale sector help young entrepreneurs starting new industries, in generating employment and creating new industrial activity in backward and rural areas to fulfil the goal of balanced regional development.

— Sales-tax, excise duty and customs ultimately go into the price of the goods which the consumer pays.
— Except nominal sales-tax, levied by the Centre on inter-state sales, tax on sales falls within the jurisdiction of States.
— Higher customs and excise duties are generally levied on items of luxury purchases.
— Items of mass consumption are either free of excise duties or are charged noninally.
— Specific excise duties are levied on 135 items. On other items, excise duty of 2 percent is levied, but exemption is granted to any unit whose annual turnover does not exceed Rs 3 million.
— Relief from excise duty is also provided in case of small-scale undertakings, and also depending upon whether the undertaking is operated manually or with power, and the items produced. Hand-spun yarns and hand-woven fabrics and small newspapers are completely exempted from excise duty.
— In the context of regional development, certain states provide relief from the levy of sales-tax, on certain items produced in their territories.

## III. ORIENTATION OF FISCAL POLICY: OTHER (NON-TAX) FIELDS

As regards:

(i) **Subsidies:**

(a) Subsidies up to 15 percent of capital employed are given for establishment of industries in backward areas, subject to a maximum of Rs 15 lacs.[2]

(b) A subsidy equivalent to 50 percent transport costs of raw materials as well as of finished products is granted between the nearest rail head and the location of the unit in selected backward areas.

(ii) **Special low interest loans:**

Special low interest on long term loans of 15 years is given at a nominal rate for establishing industries in backward areas.

(iii) **Providing infrastructure in particular areas:**

Infrastructure facilities such as land, water, power, etc. are provided in backward areas at special concessional rates. Industrial estates are also established in backward and rural areas.

(iv) **Others (e.g. the creation of free trade zones and: allied facilities):**

A free trade zone in Kandla (a backward area) has

2. 1 lac = 100,000.

been created for 100 percent export-oriented industries. Similarly, a special zone for export-oriented electronics industry has been established in Santa Cruz (Bombay).

Apart from granting general tax incentives, subsidies, finance on concessional terms are also provided for industrial activities in backward and rural areas. Infrastructure facilities have also been provided by establishment of a number of industrial estates in the country and providing land, water and power at concessional rates. This policy leads to achieving the socio-economic goal of integrated development of backward and rural areas.

## IV. EVALUATION

India continues to have a planned economy after achieving indepence with planned development programmes evolved by the Planning Commission. Fiscal and monetary policy has been so directed to achieve a rapid economic and industrial growth throughout the country. India is a vast country, full of natural resources and provides an excellent base for the establishment of a variety of industries. Among the favourable factors for establishing any industry in this country, mention can be made of its large population, developing economy, vast sheltered market and abundance of technological and skilled man-power. While India does import highly sophisticated technology from abroad, it has also developed various technologies of its own in certain fields and is in a position to render financial and technological assistance to other neighbouring developing countries. Indian scientists and technicians have also made valuable contributions in international fields in regard to scientific research and technological development. The country's export performance has been creditable and it has now accumulated substantial foreign exchange resources to meet its import and other foreign exchange requirements.

The present thrust of Government policy is the removal of regional imbalances, development of agriculture, and economic and industrial development of rural and backward areas. Various tax incentives have gone a long way in developing backward areas, increasing production, providing greater employment opportunities and in accelerating exports. Apart from tax incentives, central subsidies, transport subsidies, infrastructural facilities by way of cheaper land for industries, supply of power, electricity, water, etc. at a cheaper rate, fiscal concessions and establishment of industrial areas are contributing a great deal to balanced regional development of the country.

To illustrate the above evaluation, it may be mentioned that the financial institutions which re-finance the small-scale sector received, 6,075 applications in 1974-75, which number has gone up to 13,800 in 1976-77. The amount of re-finances which came to Rs 760 million in 1974-75 has risen to Rs 1,740 million in 1976-77. Similarly, in specified backward districts, total financial assistance given by the Industrial Development Bank of India (IDBI) which came to Rs 680 million in 1974-75 has gone up to Rs 1,450 million in 1976-77. These illustrations clearly substantiate the claim that the policy of encouraging the small-scale sector as well as establishment of projects in backward and rural districts/areas is being implemented with a measure of success and the country is making steady progress towards its socio-economic goals.

**LIST OF TAX TREATIES**

**Concerning comprehensive double taxation treaties on income**

**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Austria | income | September 24, 1963 | English | AP treaties<br>SUPP. SER. Section C<br>27 (BULL) 1964<br>IX UN A(1) 117<br>Treaty Series, Vol. 545, p. 200<br>Kanga/Palkhivala, Vol. II, 1976 |
| Belgium | income | February 7, 1974 | English, Indi and French | AP treaties<br>SUPP. SER. Section C<br>Kanga/Palkhivala, Vol. II, 1976<br>IX UN A(1) 358 |
| Denmark | income | September 16, 1959 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 74<br>Kanga/Palkhivala, Vol. II, 1976 |
| Egypt (U.A.R.) | income | February 20, 1969 | English | AP treaties<br>BULL Supplement B, 1971<br>Kanga/Palkhivala, Vol. II, 1976<br>ITR, Vol. 2, 1969<br>IX UN A(1) 273 |

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Finland | income | June 23, 1961 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 80<br>Kanga/Palkhivala, Vol. II, 1976 |
| France | income | March 26, 1969 | Hindi and French | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 272<br>Treaty Series, Vol. 748, p. 55<br>Kanga/Palkhivala, Vol. II, 1976<br>ITJ, Vol. 1, 1970 |
| German Federal Republic | income | March 18, 1959 | Hindi, English and German | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 28<br>Kanga/Palkhivala, Vol. II, 1976 |
| Greece | income | February 11, 1965 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 82<br>Treaty Series, Vol. 606, p. 10<br>Kanga/Palkhivala, Vol. II, 1976<br>ITJ, Vol. 1, 1967 |
| Japan | income | January 5, 1960 | English | AP treaties, as amended<br>IX UN A(1) 46<br>Kanga/Palkhivala, Vol. II, 1976 |
| Supplementary protocol | income | April 8, 1969 | English | Kanga/Palkhivala, Vol. II, 1976<br>ITJ, Vol. 1, 1971 |
| Exchange of notes | exchange of information | November 30, 1974 | English | Kanga/Palkhivala, Vol. II, 1976<br>ITR, Vol. 98: Part 6, Febr. 10, 1975 |
| Malaysia | income | October 25, 1976 | Malay, Hindi and English | AP treaties<br>ITR, Vol. 107: Part 8, May 23; Part 10, June 6, 1977 |
| Norway | income | July 20, 1959 | English | AP treaties<br>IX UN A(1) 42<br>Kanga/Palkhivala, Vol. II, 1976 |
| Sierra Leone | income | DTR (Dominions) Rules, 1956 | English | AP treaties<br>Kanga/Palkhivala, Vol. II, 1976 |
| Sri Lanka | income | September 10, 1956 | English | AP treaties<br>Kanga/Palkhivala, Vol. II, 1976 |
| Sweden | income | July 30, 1958 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 16<br>Kangala/Palkhivala, Vol. II, 1976 |

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties.
BULL = Bulletin for International Fiscal Documentation.
SUPP.SER. Section C = Supplementary Service to European Taxation, Section C.
DTR (Dominions) Rules = The Income Tax (Double Taxation Relief) (Dominions) Rules, 1956.
ITJ = The Income Tax Journal, Madras.
ITR = The Income Tax Reports, Madras.
Kanga/Palkhivala = Kanga and Palkhivala's The Law and Practice of Income Tax, by N.A. Palkhivala and B.A. Palkhivala, Bombay 1976, 7th edition.
Treaty Series = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official test of each agreement, this publication produces a translation in either English or French as the case may be.
UN = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes.

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**PAKISTAN:**

# Tax Structure and Fiscal Policy

**by N. M. Qureshi***

This paper is an attempt to reflect fiscal policy orientation in the field of governmental finance with reference to Pakistan. It tries to explain the objectives that underly the policy and attempts, where necessary, to evaluate the effects of fiscal measures in terms of achievement. As Pakistan's economy is in a process of development, the paper, as far as possible, brings out in relief the relationship of economic development to public finance.

## I. CATALOGUE OF TAXES IMPOSED AT THE NATIONAL LEVEL AND THEIR BASIC STRUCTURE

The Federal Government levies income tax, wealth tax, estate duty, gift tax, sales tax, excise duties and customs duties. These are briefly described below.

### Income tax

Income tax is charged on income of a person which arises, accrues or is received in Pakistan. Agricultural income has also been recently made liable to tax, but the charge of tax has been deferred for the present, as the required material to provide the precise basis of its levy is still being collected. While persons resident in Pakistan are liable to tax on their world-wide income, non-residents attract tax only on their income having its source in Pakistan. Rates generally vary with the class of persons liable to income tax. In the case of an individual, association of persons, un-registered firm and Hindu undivided family, the tax rate increases gradually up to 50 percent. Registered firms are not liable to income tax; but are liable to super-tax which varies from 5 percent to 30 percent on amounts exceeding 15,000 Rs. Companies are charged to income tax and super-tax at the rates of 30 percent and 20 percent respectively. Reduction in the rate of super-tax is admissible to certain categories of domestic companies, while foreign companies are charged to tax at the maximum rate. Income from dividends and capital gains is subject to a concessionary tax treatment. From January 1, 1978, a 10 percent surcharge on tax collections from most incomes has also been levied.

### Wealth tax

The tax is levied on the net wealth of an individual. The tax is charged on net assets exceeding the exemption limit of 200,000 Rs. in case of persons who exclude one residential house from their total assets, and on net assets exceeding 300,000 Rs. in all other cases. The rates vary from 0.5 percent on 200,000 Rs. of net wealth to 2.5 percent on net wealth exceeding 1,700,000 Rs.

### Gift tax

This tax is levied on all persons (both resident and non-resident) including companies. The tax is charged on all gifts, including certain transfers, made in the previous year on a graduated scale rising to 30 percent.

### Estate duty

The estate duty is levied on the principal value of the property which passes on the death of a person, excluding the property dedicated by endowment for religious purposes. The rates of estate duty are progressive with a minimum of 20 percent on the amount exceeding the prescribed exemption limit of 300,000 Rs. and a maximum of 75 percent on the amount exceeding 5,000,000 Rs.

### Sales tax

All items imported from abroad or manufactured in Pakistan are liable to general sales tax at a rate of 20 percent unless otherwise provided through statutory notifications, which provide a wide range of exemptions.

### Customs duties

Customs duties are levied on goods imported into or exported out of Pakistan. The rates are either ad valorem or specific and are indicated in the Pakistan Customs Tariff. With the exception of a few items like tea, tobaccao, betel nuts, yarn of man-made fibres, sugar, alcoholic beverages and cinematographic films, almost the entire tariff consists of ad valorem rates of duty. Export duties are levied quite sparingly in the light of market conditions at home and abroad.

### Central excise duties

Central excise duties are levied on all excisable goods produced in Pakistan, as set forth in the First and Second Schedules to the Central Excises and Salt Act. The scope of excise duty has expanded from 15 items, in 1947, to 63 items produced and manufactured and 2 services to date. Of these, 43 items and one service are presently charged to excise duty. Most of the consumer products of large-scale manufacturing industry in the country are covered by central excise duty.

**Total revenues and percentage of GNP**

(Rs. in million)

| Year | G.N.P. | Per capita income (Rupees) | Total revenue | Collection of direct taxes | Percentage of direct taxes to G.N.P. | Percentage of total revenue to G.N.P. |
|---|---|---|---|---|---|---|
| 1950-51 | 20,740 | 257 | 1,231.2 | 132.4 | 0.64 | 5.94 |
| 1960-61 | 34,786 | 343 | 1,942.7 | 397.3 | 1.09 | 5.58 |
| 1970-71 | 73,731 | 559 | 6,226.8 | 1,020.3 | 1.38 | 8.44 |
| 1972-73 | 60,900 | 933 | 6,766.6 | 1,162.7 | 1.91 | 11.11 |
| 1976-77 | 1,35,230 | 1,842 | 15,310.8 | 1,697.8 | 1.99 | 11.32 |

* Chairman, Central Board of Revenue, Pakistan.

## II. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, ESTATE AND GIFT

The policy objectives underlying the tax legislation in Pakistan are:

(i) generating economic surplus and taking away the same through taxation;

(ii) providing sufficient incentives to attract both domestic and foreign investment and promoting industrialisation of selected less-developed areas of the country;

(iii) achieving maximum economic growth within the framework of economic stability and social justice; and

(iv) of late, emphasis on distributional aspect has become increasingly important.

Emphasis on fiscal measures has varied during the past three decades of the country's existence. Fiscal measures during this period were designed substantially to further the strategy of development outlined in the various five-year plans. The first and second five-year plans laid stress on the production of consumer goods which, for the most part, used to be imported. Fiscal policy was accordingly gared towards creating, through tax incentives, a climate propitious for the establishment of import-substitution industries. The emphasis shifted to import-substituting investment in capital goods industries during the third five-year plan period. Tax measures were used as a vehicle for creating a bias in favour of investment in capital goods industries.

With the capital-intensive industries having been taken over by the Government as from January, 1972, fiscal measures have been pressed into service as a lever for strengthening the public sector industries on the one hand and attracting the private sector investment to consumption goods industries on the other.

The various components of fiscal policy at present operative under the income tax, wealth tax, estate duty and gift tax laws with respect to their role in mobilising investment, trade, transfer of technology, diversification and selectivity, etc. are described in the following subsections.

### A. Investment (domestic and foreign)

Creating a favourable climate for investment has all along been the cornerstone of the country's tax policy; only the emphasis has varied from time to time to suit the strategy of development planning. Since the sixties, fiscal measures have been taken to encourage savings both at the individual and at the corporate levels and consequent investment in the productive sectors of the economy. The major measures thus far taken are:

#### *1. Income tax*

(a) *Tax holiday scheme* — The scheme was introduced in 1959. It had two major objectives: to accelerate industrial growth in the country, and to encourage this dispersal of industries to less-developed regions. Under this scheme, new industries set up between 1959 and 1965 were granted a tax holiday for 8, 6 and 4 years, respectively, depending on their location, with the longer period for less-developed areas. For industries set up between 1965 and 1970, the period of tax holiday was reduced to 6, 5 and 2 years, respectively. The period exemption was abolished in 1970 for relatively developed areas; the period of tax holiday reduced from 4 to 3 years for the semi-developed areas: under-developed areas continued to be eligible for a tax holiday of 6 years (Section 15BB of Income-tax Act, 1922).

(b) *Investment allowance* — Newly-established industries (engaged in the manufacture of goods or materials; ship-building; generation, transformation, transmission or distribution of electrical energy, supply of hydraulic power; working of mines, oil-wells or other sources of mineral deposits; or any other undertaking which is approved by the government) enjoy tax exemption of their profits equal to 10 percent of the capital in underdeveloped areas and at the rate of 5 percent in other areas (Section 15B of Income-tax Act, 1922).

(c) *Depreciation allowance* — Except in the case of ships, depreciation allowances are admissible on the historical cost basis. An initial depreciation at the rate of 25 percent is allowed on new plants and machinery during the year of installation in Pakistan. Special depreciation at the rate of 15 percent is allowed for new machinery installed between July, 1970 and June 30, 1980, to companies registered under the Companies Act, 1913. An initial depreciation allowance at the rate of 15 percent and 10 percent is allowed on industrial and other buildings respectively. Industrial housing is allowed an initial depreciation allowance at the rate of 25 percent. An extra allowance of up to 50 percent of the normal allowances may be given for most items of plant and machinery where double shifts are worked, and up to 100 percent where triple shifts are worked (Section 10(3) of Income-tax Act, 1922).

(d) *Tax credit for investment* — Where a company invests any amount in the purchase of shares issued by a company formed under the Companies Act, 1913, a credit for the amount so invested is given to the company. The allowance is admissible at a rate of 15 percent for somewhat industrially developed areas; a rate of 30 percent is available for under-developed areas. Companies registered outside Pakistan are not entitled to the tax credit (Section 15FF of the Income-tax Act, 1922).

(e) *Tax credit for investment by companies in shares and debentures* — Companies investing in shares and debentures of the Equity Participation Fund (meant for promoting industrial investment in less-developed areas) are allowed a tax credit equivalent to 50 percent of the amount so invested. The investment allowance is available on the first investment, and is reduced to 50 percent if the investment shoudl subsequently be disposed of. The concession is available to both domestic and foreign companies (Section 15G of the Income-tax Act, 1922).

(f) *Tax credit for investment in balancing or modernisation or replacement of machinery* — Where a company installs any machinery for the purposes of replacement or modernisation or balancing of its existing machinery in its industrial undertaking, a credit equal to 15 percent of the actual cost of such machinery is allowed against the tax payable by that company (Section 15GG of the Income-tax Act, 1922).

(g) *Tax exemption for investment companies* — Income of investment companies registered under the Investment Companies and Investment Adviser's Rules, 1971 is exempt from income tax. The exemption is allowed only to those companies that have 90 percent public shareholding and distribute not less than 90 percent of their profits as dividends. The dividends paid out of the capital gains of investment. The dividends paid out of the capital gains of investment companies and the distribution out of the capital gains of the public sector National Investment Unit Trust (NIT) and Investment Corporation of Pakistan (ICP) Mutual Funds are taxed as capital gains in the hands of the recipients (Section 4(3)(ix a) of the Income-tax Act, 1922).

(h) *Other incentives* — Tax relief is available to a taxpayer in respect of investments made in accordance with the various provisions of the Income-tax Act up to 30 percent of his total income, subject to a maximum of 20,000 Rs. The approved channels are the purchase of newly issued shares of approved domestic companies formed under the Companies Act, 1913, defence saving certificates, NIT Units, etc. (Section 15 of the Income-tax Act, 1922).

— Dividends paid by a foreign company out of its profits from a Pakistani source to a non-resident shareholder of the company are exempt from income tax (statutory notification).

— Interest arising on foreign currency accounts held with a scheduled bank in Pakistan is exempt from income tax. The concession is available to both resident and non-resident persons (statutory notification).

— Foreign companies extending loans to their Pakistani subsidiaries or branches, or a Pakistani, at a rate of interest lower than the prevalent market rate are charged to tax on the amount so received rather than imputing their income on this account (statutory notification).

— Interest payable on loans made by approved foreign institutions, or on approved loans taken by industrial undertakings in Pakistan, for the purchase of plant and machinery, enjoy complete exemption from Pakistan income tax (statutory notification).

— In order to encourage investment in the housing industry, for houses with an annual rental value not exceeding 12,000 Rs., there is no tax on the first 6,000 Rs. Large housing estates where monthly rent does not exceed 300 Rs. are exempt for a period of 5 years (Section 4(3)(xii(b) and Section 4(3)(xiia) of the Income-tax Act, 1922).

— Dividends distributed by companies registered under the Companies Act, 1913, or the distributions of profits by the NIT and ICP out of the income of a mutual fund are exempt from income tax in the hands of the recipients, subject to the prescribed limits. The entire amount of dividends paid by the public companies registered between July 1, 1977 and June 30, 1980 out of their profits for the period up to June 30, 1982 is exempt from income tax (Section 4(3)(x) of Income-tax Act, 1922).

— Interest on approved debentures is exempt from income tax up to the prescribed limits (Section 4(3)(xviii) of the Income-tax Act, 1922).

— The amount representing bonus shares which were until recently exempt only in the hand of the recipients has also been exempted in the hands of the company issuing such shares (statutory notification).

— Income tax is not levied on money brought into Pakistan through normal banking channels by non-residents.

2. *Wealth tax*

Wealth tax is not payable in respect of the following:

(i) the rights under any patent or copyright belonging to the taxpayer;
(ii) the rights in any insurance policy prior to the moneys covered by the policies having become due;
(iii) the tools and implements used for raising of agricultural produce;
(iv) the tools and instruments necessary to carry on a profession or vocation, subject to a maximum of 20,000 Rs. in value;
(v) assets of public companies formed under the Companies Act, 1913, prior to June 30, 1963. Foreign companies are not entitled to this concession.

3. *Estate duty*

The following amounts are not liable to estate duty:

(i) proceeds of life insurance to the extent of an aggregate sum of 50,000 Rs.;
(ii) agricultural land and buildings thereon, the aggregate principal value of which does not exceed 10,000 Rs.;
(iii) one residential house;
(iv) jewellery up to the value of 25,000 Rs.;
(v) property given for the exclusive use of the Government;
(vi) works of art, drawings, paintings, patents, books, manuscripts, etc. bequeathed to the Government, a university, or a public institution;
(vii) tools and implements used by the deceased for the purposes of the profession or vocation carried on by him or for scientific research;
(viii) provident funds of salaried employees;
(ix) growing crops, draught animals, tools, implements, equipment, plant or machinery used by the deceased for raising agricultural produce; and
(x) household effects, wearing apparel, furniture or provisions, being the property of the deceased and intended for his own use or for the members of his household.

4. *Gift tax*

Gift tax is not leviable on the gift of insurance policies or other annuities (up to 5,000 Rs. only) to a dependent.

**B. Trade (domestic and foreign)**

The tax laws in Pakistan are generally not oriented to providing any special relief to income from trade and business activities. Persons engaged in such activities are entitled to most of the tax benefits otherwise available under the Income-tax Act. In the case of non-residents no income is imputed on account of operations confined to the purchase of goods in Pakistan for the purposes of export of such goods.

Special rebates in income tax and super-tax were, however, introduced in 1963. The rebates were allowed on the income of domestic companies formed under the Companies Act, 1913, which made sufficient arrangements for declaring divididends, as well as to taxpayers, other than companies, from the proceeds of the sale of goods exported out of Pakistan. The rates of the rebate varied for companies and other taxpayers, also depending upon whether or not the goods exported were manufactured in Pakistan. Certain items such as tea, raw cotton, raw jute and jute-manufacture, etc., were excluded from the purview of this provision. In subsequent years, the maximum amount of rebate was increased from 20 percent to 25 percent in respect of income attributable to export of goods manufactured in Pakistan. From the year 1973, the list of items to be excluded from the operation of this concession was restricted to raw cotton only, since Pakistan had no tea or jute available for export. Presently, income tax and super-tax on income attributable to the export of goods manufactured in Pakistan is allowed a rebate of 50 percent of such tax.

In order to meet its need for fertilisers, the Federal Government in 1970 exempted the interest arising from funds borrowed from United Kingdom banks for the purchase of fertilisers. This concession is still operative.

The Federal Government has exempted the income of the Chambers of Commerce and Industries with a view to providing a platform to the business community for exploring meaningful avenues of investment and trade.

The wealth tax, gift tax and estate duty laws generally do not contain any provisions for the extra-concessional treatment of persons engaged in trade and business. The stock-in-trade is deemed part of the total assets for the purposes of these taxes.

**C. Transfer of technology, know-how and managerial skills**

The following concessions are available under the tax laws for encouraging the import of foreign technology and managerial skills in the country:

(a) Salary income of expatriate technicians with specialised knowledge and experience in industrial arts and science, engaged in industrial undertakings in selected areas, is exempt from income tax in Pakistan for a period of three years, subject to a similar exemption to such income by the country of origin of such persons. The concession thus extends the total benefit to the individual technician rather than the exchequer of the foreign government (Section 4(3)(xiii) and (xiii a) of Income-tax Act, 1922).

(b) Technical know-how fees payable to a non-resident person for rendering technical advice to an approved public sector industrial undertaking in Pakistan are exempt from Pakistan tax (statutory notification).

(c) All foreign nationals employed in Pakistan under the terms of an aid or grant arrangement are exempt from income tax, if their salaries are paid out of such aid or grant (statutory notification).

(d) Lately, the income of Pakistani companies derived from furnishing of consultancy services abroad or through the sale of trade marks, patents, technical data and services, etc., has been exempted from income tax in the year of remittance of this amount to Pakistan. This should help in encouraging Pakistani companies engaged in development and dissemination of scientific skill abroad (statutory notification).

**D. Diversification and selectivity**

1. *As to countries from which investment, technology, etc., is solicited*

While Pakistan has taken a number of fiscal measures to raise domestic resources for investment and develop necessary technology, it welcomes foreign investment and technology suited to its development programmes.

Both public as well as private sector industries are encouraged to import capital and technology not available in Pakistan. The developed market-economy countries have historically been the primary sources of capital and technology. Lately, the emphasis in attracting investment has shifted to neighbouring OPEC countries and the remittance of funds by Pakistanis working abroad. A large numer of Pakistani companies are also engaged in extending assistance abroad, especially in the areas of engineering and consultancy.

2. *As to types or areas of investment, trade, etc.*

Investment from abroad is encouraged both in capital and consumer goods industries. Foreign investment in the form of loans and grants as well as direct investment by foreign entrepreneurs has been made especially in the pharmaceutical, chemical, fertiliser, automobile-assembly and light or heavy engineering industries, and in exploration for oil or mineral resources. Technical know-how in the form of patents, trade marks and services has been welcomed in all areas where domestic technology is not well-developed.

As respects the various tax incentives given to enterprises, both foreign and domestic, engaged in preferred areas of investment, etc., these are:

(i) *Oil exploration and development industry*

Special concessions have been accorded to industries engaged in exploration for and extraction of oil and gas. All expenditure, including abortive expenditure on the drilling of a dry hole, allocable to a surrendered area, can be offset against current income (other than dividends) or future income; on physical assets acquired before or after the commencement of commercial production, depreciation allowance is allowed. Further, a depletion allowance at the rate of 15 percent of well-head value of production subject to a maximum of 50 percent of net income before allowing depletion allowance is admissible. The sum total of royalties and taxes on income is subject to a maximum of 55 percent of profits prior to the deduction of royalties and connected levies. Income from the renting of extra-pipeline capacity of an enterprise engaged in oil exploration is also subject to concessionary tax treatment. Foreign companies are also extended safeguards against future fluctuations in the exchange rate through reduction in the amount of tax payable during the year of revaluation or devaluation of the Pakistan Rupee.

(ii) *Mining industry*

The undertakings engaged in exploration for and extraction of mineral deposits are allowed a deduction of all expenditure incurred prior to commercial production, as well as a depreciation allowance at a rate of 100 percent in respect of all expenditure incurred on machinery and equipment, a depletion allowance at a rate of 15 percent of total income or 50 percent of the capital employed, whichever is less, and an exemption of profits equal to 50 percent of capital employed in case the mineral in question is also refined or concentrated.

(iii) *Agriculture – oriented industries*

Income from poultry farming, dairy farming, fish catching, cattle or sheep breeding, production and sale of agricultural implements, rendering of agricultural services is exempt from income tax for the prescribed period (Section 4(3) of the Income-tax Act, 1922).

(iv) As to the diversification of domestic and foreign trade, tax as well as non-tax measures have been taken (See II. B. above).

3. *As to regional or special areas*

The Government has laid great emphasis on the dispersal of industries in the less-developed regions of the country by providing longer tax holiday periods and tax credits for investments in such areas. Non-fiscal measures in the form of providing the necessary infrastructure and financial resources have also been followed. Industrial estates were carved out in those regions where local expertise and raw material were easily available.

## III. ORIENTATION OF FISCAL POLICY: SALES TAX, EXCISE DUTIES, CUSTOMS

The government is committed to a policy of re-distribution of wealth and income. The scheme of indirect taxation is accordingly oriented towards achieving this end. Luxury goods and non-essential items consumed or used by the rich are taxed at the highest rates while necessities, semi-necessities and products of cottage industries are taxed at low rates.

1. *As regards redistribution of wealth*

| | | |
|---|---|---|
| a. | Items of luxury and non-essential goods | High rates |
| b. | Imported cereals | Free |
| c. | Imported agricultural products | Low rates |
| d. | Imported raw materials | Low rates |
| e. | Imported machinery and parts and accessories thereof | Low rates |
| f. | Sales tax on necessities | Free |
| g. | Sales tax on semi-necessities | Low rates |
| h. | Sales tax on products of cottage industry | Free |
| i. | Hotels and restaurants frequented by persons of high income group | Duty levied |
| j. | Imported second-hand clothing | Free |
| k. | Imported coloured televisions | Dutiable |
| l. | Import duty on motor cars | High rates |

2. *As regards employment*

Lately, emphasis has also been laid on the establishment of labour-intensive industry. In the construction sector, which is labour-intensive, fiscal encouragement is given for construction of small houses; moreover, many low-cost housing projects in the public sector are in various stages of execution. Special provision is made to encourage house construction activity in the private sector, and credit facilities to all income groups are offered by the House Building Finance Corporation.

Fiscal incentives are provided to hundreds of thousands of poor workers and potential entrants by exempting from excise duty units equipped with four power looms or less that manufacture cotton fabrics. The government assists in the establishment of small industries through liberalisation of import policy and easier provision of credit through the peoples' Finance Corporation.

The government also makes considerable investment in projects that use machinery produced in the country. Substantial allocation of funds is made in the public sector for agro-related industries meant either for producing agricultural inputs such as fertilisers or for processing agricultural commodities such as sugar cane and cotton. As a result of these fiscal measures, thousands of new jobs are created every year.

3. *As regards regional development*

In order to attract investment to the under-developed areas of the country, various fiscal incentives are provided. The most important of these incentives are (1) a tax credit for investments, and (2) a partial or full exemption of import duty allowed on plant and machinery imported for under-developed areas.

## IV. ORIENTATION OF FISCAL POLICY: OTHER (NON-TAX) FIELDS

1. *Subsidies:* In pursuance of the government policy of providing subsidies to the most essential items, wheat, both imported and indigenous, is given subsidy, as the item is used by the masses and considered essential as a price stabilisation measure. Other subsidies include the cost of distribution of wheat, kerosene oil, sugar and salt. Normally, the government bears the differential between the import or procurement cost and the issue price of wheat. In special cases, the government also meets the incidental price differences. Lately, the government has also exempted from income tax so

much income of a person as represents a subsidy granted by the Federal Government for the purpose of implementation of an approved project. In 1976-77 subsidies amounted to 1.15 percent of expenditure on gross national product at market prices.

2. *Special low interest loans*

There is no discrimination in the rate of interest in so far as its ultimate use is concerned. Recently, a lower rate of interest has been provided for exports.

3. *Providing infrastructure in particular areas (e.g. industrial estate)*

The *transport system* continues to increase in capacity, and in the case of ports, additional capacity is under construction. Owing to the long gestation nature of the projects, relief is not expected to be available immediately. The main thrust of the programme relating to the Pakistan Railways aims at accelerating the work for the improvement of the line capacity by introducing the battery system along the main line, streamlining procedures for marshalling and running goods trains on a fixed time-table. Rehabilitation and renewal of tracks, expansion and modernisation of workshops and replacement of depreciated rolling stock have been accorded priority. Under the Federal Road Development Programme, 801 miles of roads were constructed and 553 miles of existing roads were improved during the 1972-76 period. The provincial Road Development Programme covered improvement of 1690 miles of existing roads and construction of 1157 miles of new roads during the same period. The target for 1976-77 aimed at 3,200 miles of new construction or improvement of roads in the country. Special attention was paid to extending the telecommunication facilities towards the rural and outlying areas. All T.V. transmitting stations except Quetta were connected on a national microwave net-work. The total number of telephones increased from 167,000 in 1971-72 to 228,000 in 1974-75, while the target which comprised installation of 23,000 telephone lines during 1975-76 was fully achieved. The target set for 1976-77 included installation of 30,000 telephone lines together with ancillary work. Most cities or towns are linked with telephones operating on a micro-wave system.

The *foreign private Investment (Promotion and Protection) Act,* of 1976 authorises foreign private investment in desirable industrial undertakings not existing in Pakistan, or not being carried on at an adequate scale or which will contribute to the development of capital, technical know-how, discovery and mobilisation of domestic resources, increasing employment opportunities, etc. Apart from ten basic industries reserved for public sector and the armament industry, private investment is welcome in all other industrial fields. The Act provides investment as well as profit from reinvested profits and foreign currency loans. Industrial undertakings financed with foreign capital are accorded the same tax treatment as those financed with domestic capital, and are not subjected to other or more burdensome taxes on income. Foreign nationals employed in Pakistan are allowed monthly remittances for the maintenance of their dependents in the home country equivalent to 50 percent of their salary. While *nationalising the basic industries,* immunity has been granted to all the industries financed with foreign capital.

4. *Others (e.g. the creation of free-trade zones and allied facilities)*

The Government has recently instituted a duty-free area in Karachi for the purpose of installation of export-oriented industries. (See above).

## V. EVALUATION

The various fiscal measures taken in the recent past have yielded results. While results in certain sectors are not amenable to a quantitative measurement due to long gestation periods of certain projects, results in otherss have been perceptible. There has been a quantum leap in earnings from exports and in revenue collections. The value of exports during 1972-73 was of the order of 8,623,000 Rs.; in 1976-77, it amounted to 11,420,000 Rs. Similarly, the proceeds of taxation which amounted to 6,767,000 Rs. in 1972-73 increased to 15,311,000 Rs. in 1976-77.

As respects increased investment in the industrial sector and the dispersal of industries to the less-developed regions of the country as a result of tax holidays and tax credit schemes — although it is difficult to evaluate in concrete terms of industrial development — it is conceivable that these measures diverted funds from other sectors to the industrial sector and the tax exemption made relatively larger resources available for self-financing than would have been possible otherwise.

The various fiscal measures encouraging import of foreign investment and technology have not only provided additional job opportunities but also had a favourable effect on gradual transfer of sophisticated skills to Pakistani nationals.

The impact of foreign investment on domestic investment has not been adverse as the former does not compete with the latter, the projects mostly being such as involve sophisticated technology the like of which is not locally available.

## LIST OF TAX TREATIES

### Concerning comprehensive double taxation treaties on income/capital

### The list is up to date as of March 31, 1978

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Austria | income | July 6, 1970 | English | AP treaties<br>SUPP. SER. Section C<br>Raza Naqvi, Vol. I, 1972 |
| Canada | income | February 24, 1976 | English | AP treaties |
| Denmark | income | September 4, 1961 | English and Danish | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 98<br>Raza Naqvi, Vol. I, 1972 |
| France | income | July 22, 1966 | English and French | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 265<br>Treaty Series, Vol. 678, p. 243<br>Raza Naqvi, Vol. I, 1972 |
| German Federal Republic | income | August 7, 1958 | English and German | AP treaties, as amended<br>SUPP. SER. Section C, as amended<br>IX UN A(1) 25<br>Raza Naqvi, Vol. I, 1972 |
| Additional Protocol | income | August 27, 1963 | English and German | IX UN A(1) 137<br>TAXL 1974, Vol. 29 |
| Supplementary agreement | income | January 24, 1970 | English and German | IX UN A(1) 254<br>TAXL 1974, Vol. 29 |
| Ireland | income | April 13, 1973 | English | AP treaties<br>SUPP. SER. Section C<br>TAXL 1975, Vol. 31 |
| Japan | income | February 17, 1959 | English | AP treaties, as amended<br>Raza Naqvi, Vol. I, 1972 |
| Supplementary protocol | income | June 28, 1960 | English | Raza Naqvi, Vol. I, 1972 |
| Libyan Arab Republic * (People's Socialist Libyan Arab Jamahireya) | income | January 9, 1975 | English | AP treaties<br>IX UN A(1) 361 |
| Malta * | income | October 8, 1975 | English | AP treaties<br>IX UN A(1) 365 |
| Poland * | income | October 25, 1974 | English | AP treaties<br>SUPP. Ser. Section C |
| Sweden | income | August 25, 1958 | English | AP treaties<br>IX UN A(1) 18<br>Raza Naqvi, Vol. I, 1972 |
| Sri Lanka | income, capital | May 19, 1969 | English and Sinhala | AP treaties<br>IX UN A(1) 276<br>Raza Naqvi, Vol. I, 1972 |

* Not yet in force.

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Switzerland | income | December 30, 1959 | English and German | AP treaties, as amended<br>SUPP. SER. Section C, as amended<br>IX UN A(1) 35<br>Raza Naqvi, Vol. I, 1972 |
| Additional protocol | income | June 15, 1962 | English and German | Raza Naqvi, Vol. I, 1972 |
| United Kingdom | income | April 24, 1961 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 62<br>Raza Naqvi, Vol. I, 1972 |
| U.S.A. | income | July 1, 1957 | English | AP treaties<br>Raza Naqvi, Vol. I, 1972 |

**Abbreviations:**

| | |
|---|---|
| AP treaties | = Taxes and Investment in Asia and the Pacific. Part treaties. |
| SUPP. SER. Section C | = Supplementary Service to European Taxation, Section C. |
| Raza Naqvi | = Raza Naqvi. The Law and Practice of Income Tax in Pakistan. Vol. I. Fourth Revised Edition. July 1972 Lahore. |
| TAXL | = Taxation (Lahore). Pakistan. |
| Treaty Series | = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French as the case may be. |
| UN | = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes. |

# SRI LANKA:
# Tax Structure and Fiscal Policy

by Chuntharampillai Sivaprakasam*

Sri Lanka is an island in the Indian Ocean situated South of India. On account of its proximity to the equator it has a tropical climate with warm temperatures and a heavy rain-fall. Its total land area is 25,329 square miles, its maximum length being 270 miles and its maximum breadth 140 miles. Its present population is approximately 13 million. It was under colonial rule for over 400 years, being subjugated in turn by the Portuguese, the Dutch and the British, and finally received its independence in 1948. It is presently a Republic with a Parliamentary form of Government and its constitutional Head of State is the President. During British times plantations were opened up and the main crops were tea, rubber and coconut from which most of its export revenue was obtained. Although it is a country rich in natural resources and scenic beauty, the basic problems are still economic — unemployment, over-population, foreign exchange shortages, lack of capital resources and underdevelopment. In view of this, the economic development of the country has become the main focus of attention and in this context fiscal policy has a crucial role to play in promoting specific strategies of growth. Taxation has also been used as an instrument for redistribution of both income and wealth. Over the years, taxation has been the main source of revenue collection for the Government. Taken as a proportion of the Gross National Product it is now over 20 percent which is quite high for a developing country wrestling with the problems of development.

## A. CATALOGUE OF TAXES

The catalogue of the main taxes includes:

Income tax
Wealth tax
Gift tax
Business turnover tax
Estate duty
Stamp duty
Excise duty
Import duty
Export duty
Foreign Exchange Entitlement Certificates (abolished in terms of the recent Budget)

The maximum and minimum rates applicable are set out below:

CHART I

| Name of Tax | Minimum rate % | Maximum rate % |
|---|---|---|
| Income Tax: | | |
| Resident Individuals | 7.5 | 50.0 (proposed 70.0) |
| Non-resident Individuals | 15.0 | 50.0 (proposed 70.0) |
| Resident Companies | 35.0 | 60.0 |
| Non-resident Companies | 66.0 | 66.0 |
| Wealth Tax | 0.5 | 2 |
| Gifts tax | 31.0 | 100 |
| Estate Duty | 5.0 | 70.0 |
| Business Turnover Tax | 1 | 25 |
| Import Duty | 5 | 100 |
| Stamp Duty | 6 cts per cheque leaf | 6 |

The persons liable in regard to each tax are set out below:

### Income tax

Income tax is chargeable:

(i) in the case of persons who are resident in Sri Lanka, on income arising in Sri Lanka and income arising abroad;
(ii) in the case of persons who are non-resident, only on income arising in Sri Lanka. (Income derived from services rendered in Sri Lanka or from business transacted in Sri Lanka whether directly or through an income arising in Sri Lanka).

The question of residence depends entirely on the length of an individual's stay in Sri Lanka. A company is deemed to be resident if its registered or principal office is in Sri Lanka or if the control and management of its business are exercised in Sri Lanka.

A resident individual is in general, exempt from tax if the assessable income for the year is less than Rs. 6,000.

A non-resident individual is not liable to tax if the income in Sri Lanka was solely derived from services rendered in Sri Lanka or business transacted in Sri Lanka and such income did not exceed Rs. 1,000.

### Wealth tax

Persons liable are:

(i) any person resident in Sri Lanka including Hindu undivided families (excluding resident companies);
(ii) non-resident persons (including Hindu undivided families) having property in Sri Lanka;

* B.A. (London), Attorney-at-Law, Member, UN Expert Group on Double Tax Treaties between Developed & Developing Countries, Commissioner General of Inland Revenue, and Additional Secretary, Ministry of Finance & Planning, Sri Lanka.

(iii) non-resident companies having immovable property in Sri Lanka.

Liability will arise only where the aggregated net wealth is in excess of Rs. 100,000.

**Gifts tax**

A gift is a transfer of any existing movable or immovable property by one person to another, made voluntarily and without consideration in money or money's worth.

Where a transfer is made without adequate consideration, the transfer is regarded as a gift for tax purposes to the extent of the difference between the market value of the property transferred and the consideration.

Where no consideration passes or is likely to pass, the full value is deemed to be a gift.

The release, discharge, surrender, or abandonment of any debt (other than a bad debt allowed for income tax purposes), or of any contract or other actionable claim, is a gift.

The donor is generally the person liable to gifts tax.

If the tax due from the donor cannot be recovered from him, the tax can be recovered from the donee.

Gifts not exceeding Rs. 1,000 in the aggregate for a year are exempt from tax. The rate schedule for gifts tax applies progressively to all taxable gifts made by the same donor over his lifetime, irespective of the year of assessment in which the gift is taxed.

**Business turnover tax**

Persons carrying on business in Sri Lanka are liable to the Business turnover tax.

Every business carried on in Sri Lanka which has a turnover of not less than Rs 25,000 per quarter or Rs. 100,000 in a year is liable to the tax. Certain undertakings have been specifically exempted.

**Estate duty**

Liability arises at death on the estate of a deceased person only if the total estate is in excess of Rs. 50,000.

**Stamp duty**

Stamp duty is payable at different rates on a variety of documents and is levied by reference to the value stated on each document.

**Excise duty**

Excise taxes differ from the Business turnover tax by being collected only from the producers and importers of the commodities concerned. They differ from import duties by being levied not only on that part of the supply of a commodity which is imported but also on the domestic production.

**Import duty**

Import duty is levied under section 10 of the Customs Ordinance. The classification is based on the Brussels Tariff Nomenclature. The Budget presented in November 1977 introduced a basic change in the structure. The pre-Budget system of duties functioned in conjunction with the Foreign Exchange Entitlement Certificates System (FEEC). The Budget 1978 introduced a uniform exchange rate with an extensive liberalisation of imports. In the new customs tariff specific duties have been retained for a number of commodities, but the bulk are to be taxed on an ad valorem basis.

**Export duty**

A sliding scale rate system of export duties was introduced for tea, rubber and coconuts in 1951 to absorb part of the high income being earned by producers during the Korean War boom. The sliding scale element of the system was abolished for tea and coconut products in 1953 and for rubber in 1956. Sliding scales of duties were eventually re-introduced for tea in 1959, for rubber in 1961 and for cconut products in 1963. Ad valorem export taxation of desiccated coconut was re-introduced in September 1976. The duties on tea and rubber have undergone a number of *ad hoc* structural and rate changes aimed primarily at compensating for changes in post-tax profit levels in the domestic industries caused by changing world prices and costs of production. Export duties are currently also levied on cinnamon, cardamom and citronella oil.

The Budget 1978 has introduced certain increases in the taxation of tea and rubber exports to absorb the higher rupee profits these commodities enjoy as a result of the unification of the Exchange rates.

**Foreign Exchange Entitlement Certificate Scheme**

This scheme was in operation from May 1968 until the recent budget abolished it. It was intended to provide some adjustments since the Sri Lanka rupee was overvalued. Except for a few essential items such as rice, flour, fertilisers, drugs and books, all other imports were subject to a higher rate of exchange, premium being 65 percent. On the export side, except for the traditional exports, viz. tea, rubber and coconut, other exports including receipts from tourism received a premium of 65 percent.

This scheme turned out to be a major source of government revenue as the amounts charged on imports far outweighed the amounts paid out on exports.

The recent budget abolished the above scheme and introduced a unified rate of exchange for all transactions. The exchange rate was fixed at about twice the value of the prevailing rate.

**Convertible rupee account**

The Convertible Rupee Account scheme was introduced in July 1972 to supplement the Foreign Exchange Entitlement Certificate Scheme and applied to the export of gems and certain non-traditional goods, tourism, professional and consultancy services. In terms of this scheme a specific share of the foreign exchange from these exports was transferred to a special account and the funds credited were allowed to be used to finance a broad range of expenditures including travel, education and certain imports. The rates varied from 5 to 25 percent.

Initially the Foreign Exchange Entitlement Scheme was the main attraction for non-traditional exporters. Although it provided for extra income in local currency, such incomes did not provide an opportunity to purchase imported consumer goods which were scarce in the local market. Moreover, certain other probable exports did not find their way into the official channels. In particular there was evidence to believe that the trade in gems eluded the normal channels of exports and financed a lucrative trade in smuggled goods. It was in recognition of these shortcomings that the CRA was introduced in mid-1972. In addition The State Gem Corporation was set up and tax exemptions were also granted to the gem business. These measures made a significant impact upon preventing smuggling and the national revenue from gems increased from Rs. 3 million to Rs. 150 million.

**CHART II**

**Revenue of major taxes and percentages of net revenue and GNP**

| | Income tax | | | Business turnover tax | | | Excise duty | | |
|---|---|---|---|---|---|---|---|---|---|
| | Revenue | % of net revenue | % of GNP | Revenue | % of net revenue | % of GNP | Revenue | % of net revenue | % of GNP |
| 1974 | 598 | 21.8 | 2.8 | 604 | 22 | 2.8 | 750 | 27.4 | 3.5 |
| 1975 | 770 | 28.5 | 3.2 | 646 | 23.9 | 2.7 | 831 | 30.1 | 3.5 |
| 1976 | 902 | 26.2 | 3.5 | 711 | 20.7 | 2.3 | 918 | 26.7 | 3.5 |
| | Import duty | | | Export duty | | | FEECS | | |
| 1974 | 277 | 10.1 | 1.3 | 660 | 24.1 | 3.1 | 967 | 35.3 | 4.5 |
| 1975 | 336 | 12.4 | 1.4 | 430 | 15.9 | 1.8 | 1055 | 39.0 | 4.4 |
| 1976 | 476 | 13.8 | 1.8 | 421 | 12.3 | 1.6 | 1074 | 31.3 | 4.1 |

(Rupees in millions)

Note: Net revenue does not include all current receipts and transfers. The concept refers to tax revenues less food subsidies and transfers to corporations.

## B. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, ESTATES AND GIFTS

### 1. Investment and trade (domestic and foreign)

Prior to the Kaldor reforms in 1958, the function of taxation was primarily revenue collection. In the sphere of direct taxes, the capacity to pay tax at that time was measured almost solely by income. The major breakthrough in tax policy took place in 1958, when the Kaldor system of taxation was introduced. The tax base was then broadened to include wealth, expenditure, gifts and capital gains and various incentives to capital formation were built into the tax structure. Along with the widening of the tax base, taxation became a kind of socio-economic regulator and an important tool for promoting economic growth. By means of a highly complex system of allowances, reliefs and rebates, the tax system came to provide the incentives to divert the increment in incomes into savings and investment, and more particularly to new lines of business activity which are considered desirable for economic development.

The incentives through the tax system took the form mainly of capital deductions and allowances, investment reliefs and tax holidays. Initially, tax exemptions were provided to stimulate import substitution industries. This policy later gave way to one where export promotion was specifically encouraged. The present policy places emphasis on both exports and production for local consumption.

Generous capital allowances have been granted to both local and foreign investment in respect of plant, machinery, fixtures and industrial buildings. The system of lump-sum depreciation allowances and development rebates given in the past is now to be replaced by a 100 percent capital allowance which amounts to allowing the full cost of plant, machinery and fixtures used in a business. In the case of agricultural and industrial buildings 50 percent of the cost of construction is to be allowed. Apart from simplicity in operation, the grant of these enhanced capital allowances will serve as a major incentive for capital investment.

Liberal investment allowances are granted to encourage investment of capital in the purchase of ordinary shares of companies approved by the Minister of Finance.

An eight-year tax holiday is available for new undertakings in respect of export profits of non-traditional items. Similarly, a five-year tax holiday is provided for new hotel undertakings in the tourist sector.

The recent Budget has offered a new package of tax holidays to further stimulate investment. In the area of housing, a special incentive has been given to the housing developer who builds and sells houses.

Five-year tax holidays are also envisaged in the following areas:

(a) non-traditional agricultural enterprises like the cultivation of cinnamon, citronella, pepper, nutmeg, cloves and cardamom;
(b) small and medium-scale industrial enterprises established outside urban areas;
(c) new companies formed for off-shore and deep-sea fishing.

## 2. Transfer of technology, know-how and managerial skills

Royalties relating to know-how, patents, etc. are taxable regardless of the nationality of the payee. The gross royalty is taxable in terms of the Sri Lanka law, as no expenses are allowed. In the more recent double taxation relief agreements, a lower rate of tax has been offered in respect of royalties on new contracts in order to promote the inflow of new technologies.

Where a foreigner is brought to Sri Lanka and employed in an approved industrial undertaking as an expert, adviser, scientist or technician, his emoluments and any income not arising in Sri Lanka are exempt from income tax for a period to be specified by the Minister of Finance after due consideration of each case.

Certain exemptions are available to foreign contractors. A person who has entered into a contract with:

(a) the Government of the Republic of Sri Lanka; or
(b) a statutory corporation or institution which is approved by the Minister of Finance for the purposes of this section,

will be exempt from income tax on the profits arising from the contract if the following conditions are satisfied:

(i) the foreign contractor should not have had a place of business in Sri Lanka whether directly or through an agent at the time he enters the contract;
(ii) the contract should have been entered into on the basis that the profits will be exempt from income tax;
(iii) the name of the foreign contractor should be gazetted by the Minister of Finance for the purpose of this section.

Where the profits of the contractor are exempt under these provisions, the foreign personnel employed by the contractor will also be exempt from income tax on their emoluments and on their foreign income.

## 3. Diversification and selectivity

Generally, the fiscal incentives offered through the tax structure would be available to all investors. In terms of double taxation relief agreements, certain specific incentives have been offered to investors from those countries. Presently Sri Lanka has agreements in force with Sweden, India, Norway, the Federal Republic of Germany, Denmark, Japan, Pakistan and Malaysia. Agreements have been initialled also with the U.K., Canada, Czechoslovakia, France, Poland and Singapore.

In terms of the new foreign investment policy adopted by the new Government and the envisaged free trade zone for exports, special importance is being paid to the negotiation of double taxation relief agreements so that the concessions intended to be given in Sri Lanka would be preserved for the benefit of the investor. The basic problem in relation to this is that any reduction in the tax burden in the country of source usually accrues to the benefit of the foreign Treasury as the full tax is charged in any case in the country of residence. In order to preserve the benefits of the reduced rates of tax and exemption granted, Sri Lanka usually insists on a corresponding tax-sparing clause in her Agreements, i.e. a special provision is included in the Agreement, whereby the tax that would be chargeable in the "source" country if no exemption or reduction were granted, be treated as tax in the "source" country for the purpose of the tax credit in the country of residence. An alternative to tax-sparing would be for the country of residence to provide a credit not merely for the tax on the dividends, but also for part of the tax paid by the company on its profits. These alternative measures have been found to be effective treaty mechanisms, as they are easily applicable, and in this way the concessions granted in Sri Lanka can be suitably integrated with the tax structure of the developed countries. In the recently concluded Double Tax Relief Agreements Sri Lanka's new policy has been to focus attention particularly on dividends, royalties and interest representing, as they do, the major forms of foreign investment, viz. equity capital, technological know-how and loan capital. Through the tax treaty medium, reduced rates of tax have been offered for dividends, royalties and interest from new investment, the benefit of which will actually accrue to the foreign investor.

Tax concessions and exemptions have been offered particularly in the area of non-traditional exports, new agricultural ventures, small and medium-scale industrial enterprises, housing, and off-shore and deep-sea fishing.

The new Free Trade Zone envisaged by the new Government is intended to be a special area of investment and trade to promote economic development, create new employment avenues and stimulate the inflow of foreign exchange and capital. A new law called the Greater Colombo Economic Commission Bill has been passed in Parliament to enable the establishment of this Free Trade Zone area and a special set of fiscal incentives which will apply only to this area will be provided for.

It is noteworthy to mention that the new tax exemptions envisaged for small and medium-scale industrial enterprises are to be granted only if such industries are established outside municipal limits. This is especially intended to foster the growth of these industries in rural and non-urban areas. This kind of regional incentive helps to open up new areas, whilst providing for new employment avenues and the commencement of ancillary services, trade centres and bazaars, promoting thus the spiralling effect of new economic activity.

## 4. Difference in treatment between the public and private sectors

Certain areas of investment have been demarcated for the private sector. The last ten years have witnessed the gradual expansion of the public sector. This is evident in the increasing public share in investment outlay and even more emphatically in the continuing need of public sector control of establishments through the nationalisation of major industries. Concerning foreign investment, the White Paper of 1972 set out the broad lines of policy. Emphasis was placed on the Government's willingness to accept foreign investment only "in certain specified fields and on terms which are considered appropriate". Foreign investors are permitted to enter proposals for participating in projects in industries reserved for the state section. Such proposals may be made either in industries already operated by the State such as paper, ceramics, oils and fats, plywood, leather goods, cement, cotton textiles and hardware; or in industries where further expansion is reserved for the State, such as heavy capital goods and mineral resources in certain basic industries. In respect of private sector projects the main spheres for foreign investment are the tourist industry, fisheries, non-traditional exports and the industrial sector. This policy will however be reviewed and expanded by the present Government particularly in view of the liberalisation of investment policies and the establishment of the Free Trade Zone.

So far as tax treatment is concerned, public sector corporations are liable to tax in the same way as companies at the same rate of tax. Foreign governments are taxed similarly. There is also no difference in tax treatment between the private and the public sectors.

A resident company is liable to a non-refundable tax of 60 percent on its taxable income and a refundable tax of 33 1/3 percent on the dividends declared out of the profits on which the taxable income is computed.

A non-resident company is liable to a non-refundable tax of 60 percent on the taxable income of the company plus a 6 percent additional levy in lieu of estate duty.

Where a non-resident company makes any remittances, it is also liable to a tax amounting to —

(a) 33 1/3 percent of its remittances abroad; or
(b) 33 1/3 percent of one third of its taxable income, whichever is less.

In order to promote broad-based ownership of shares in companies and to stimulate mass participation in the country's development, a recent measure which has been introduced is a lower rate of tax of 40 percent which would apply to People's companies where the shareholdings are diffused.

A lower rate of tax of 35 percent is also applicable to co-operatives.

A significant change introduced recently is the transference of ownership of the plantation agricultural sector to the State. Two major land reforms were implemented in the 1972-1976 period. First in 1972, a law was passed to restrict private non-company land holdings to 50 acres for each person. In the case of paddy, the ceiling land holding was limited to 25 acres. Later in 1975 a more radical bill took over rupee and sterling company estates in the tea, rubber and coconut sectors. By these legislative changes, the backbone of the economy in this country was brought under State control.

## C. ORIENTATION OF FISCAL POLICY: SALES TAXES, EXCISE DUTIES, CUSTOMS

### 1. Redistribution

The different rate bands applicable to the Business turnover tax enable the Government generally to tax goods purchased by the higher income groups more than goods bought by the lower income groups. Although the turnover tax is basically regressive in effect, the multiple rate bands have built in a progressive effect in its impact on taxpayers at different income levels. The Budget proposals for 1978 have increased the exemption limit from Rs. 100,000 and this would benefit the marginal taxpayer. The reduction in the higher rates of turnover tax announced in the recent Budget would appear to modify the progressiveness of the rates, but on the other hand, the increased rates for the assembly of motor cars and liquor might increase the progressiveness. It is also significant that essential foodstuffs like rice, flour and sugar are exempt from the turnover tax so that in this way the poorest classes whose purchases are restricted to these essential items are not called upon to pay tax.

Excise taxes on liquor and tobacco also contribute to making the entire system of taxes, transfers and subsidies, taken as a whole, more progressive and thereby have their impact on the redistribution of income and wealth. Both these commodities are known to have low price elasticities and therefore increased taxation does not affect the level of consumption much.

In relation to import duties, too, the highest duties are reserved for non-essential and "luxury" imports with a steep progression. This would therefore become applicable to the upper income and wealth brackets. On the other hand the removal of the Convertible Rupee Account in the recent Budget would reduce the benefits to the rich class of gem dealers and businessmen engaged in lucrative trades in the non-traditional export sector.

The increased export duties announced in the recent Budget will sop up the excesses in rupee profits obtained from the change in the exchange rate. In particular, the taxes on tea have diverted part of the large revenues of agricultural estates to the Government enabling it to achieve some manner of redistribution of income and wealth from the tea sector to other sectors.

Nevertheless, the results of land reform have also to be taken into account. As much as 63 percent of the tea acreage producing about 80 percent of the tea tonnage is now owned by the State. As the privately owned sector tends to produce lower priced teas, less than 20 percent of indirect tax revenue from tea derives from the private sector. The basic nature of taxation of the tea sector has therefore changed from that of primarily taxing and raising resources from private companies to that of primarily diverting resources from one use to another within the public sector.

## 2. Employment

One of the objectives of the import duties system is the protection of domestic industry. In the post 1960 period, the introduction of stringent foreign exchange controls and increased import duties provided a stimulus to local industries and businesses and this in turn promoted employment and now openings in those industries. The tax system generally favoured both import substitution and export industries and also employment opportunities in these industries. The same purpose is served by reduced duties and exemptions on basic industrial raw materials and inputs and the general liberalisation of imports introduced after the recent Budget. One objective of the new policy is to stimulate imports of intermediate goods in support of an increased local production and, in turn, an increased import of capital goods in support of a higher investment level and a consequent increase in employment opportunities.

## 3. Regional development

Regional development has been encouraged by the establishment of industries and factories in the areas where the raw materials were available. Thus, on the eastern coast of Sri Lanka, a paper factory was established at Valaichenai, and in the north at Kankasanthurai a cement factory was set up. A sheet glass factory was put up at Dankotuwa, the plywood factory at Gintota and the Paranthan Chemicals Corporation factory at Paranthan, Kilinochchi.

The proposal for establishing a Free Trade Zone in terms of the Greater Colombo Economic Commission law will further regional development in this area-north of Colombo. The system of indirect taxes and duties will not apply to this zone and the exemption thus granted will be a lever for economic activity in the region.

There is also a proposal to apply the Business turnover tax collections to regional development. In terms of the original proposal a part of the tax collected from businesses in a particular region will be allocated to local authorities in the region for regional development. This proposal has, however, not still been implemented.

## D. OBJECTIVES OF FISCAL POLICY: OTHER FIELDS

### 1. Subsidies

Sri Lanka has ever since independence paid much attention to social welfare and the granting of subsidies. Along with a progressive tax rate structure this has meant a certain measure of social justice with its redistributive impact on income and wealth. The chief areas of subsidies have been food, education and health.

There are four main items on which the Government pays consumer subsidies — rice, wheat flour, sugar and infant milk foods. The payment of food subsidies has been tied to a rationing scheme under which all individuals entitled to such subsidies are issued "ration books" or "token cards". There were approximately 12 million ration book holders and 1 million token card holders: of these, nearly 1.1 million belong to the taxpaying category for whom the subsidy given is only partial.

The increase in population over the years has resulted in an increase in subsidy expenditure. This may be illustrated by the following statistics in relation to the food subsidy.

**CHART III**

| Year | Food subsidy (Rs.million) | Net subsidy as a percent of | |
|---|---|---|---|
| | | GNP | Domestic revenue |
| 1966-67 | 201.8 | 2.24 | 9.16 |
| 1967-68 | 296.3 | 2.81 | 12.2 |
| 1968-69 | 328.8 | 2.83 | 11.82 |
| 1969-70 | 327.2 | 2.58 | 11.08 |
| 1970-71 | 536.2 | 4.21 | 18.64 |
| 1971-72 | 525.9 | 3.77 | 16.13 |
| 1973 | 679.0 | 4.07 | 17.04 |
| 1974 | 952.1 | 4.47 | 20.16 |
| 1975 | 1230.4 | 5.18 | 24.43 |
| 1976 | 937.6 | 3.6 | 16.57 |

The food subsidy has been criticized as it represents a substantial diversion for current consumption of the nation's resources. A substantial amount of foreign exchange is also spent annually on the importation of subsidized items. Thirty-seven percent of the import bill during the period 1974-76, for instance, was spent on imports or rice, flour and sugar. Food subsidies can also become disincentives to local production of cereals, sugar and their substitutes. But despite, this, in a developing country like Sri Lanka where large-scale unemployment and poverty occur, a subsidy system of some sort may be considered inevitable. With over a million unemployed, the welfare impact of the food subsidy cannot be over-emphasized.

The Budget of 1978 was significant for the abolition of the rationing system and the withdrawal of free rice and the subsidies on rice and sugar from households with incomes in excess of Rs. 3,600 per annum. The limit applies to households with 5 persons or less. There is a system of adjusted relief granted on the food subsidy to persons with larger families. No change was made in the case of subsidy on wheat flour and infants' milk food.

The new system represents a radical break from the old policy. It marks a move towards the principle that food subsidies should be granted only to the very poor. In the long run, this would effect a reduction in government expenditure, although this may not be apparent initially in the first year in view of the change in the official rate of exchange.

A new feature introduced in the Budget of 1978 is a cash subsidy scheme of income support of Rs. 50 per month payable to persons with no gainful occupation. They will receive this support until they are given employment.

In relation to the overall fiscal policy relating to taxes, subsidies and transfers, the redistributive impact may be illustrated by a few examples:
In 1976, for instance, the food subsidies required

expenditures practically equal to the revenue from income and other related direct taxes. It could also be said that the subsidies and transfers to public corporations absorbed nearly all revenue collected from FEECs. In 1975 about one-third of total revenue was returned in the form of subsidies and transfers.

In relation to development, subsidies have been granted by Government for different purposes. Generous replanting subsidies have been granted for the replanting of tea and rubber. In the area of replacement of factory machinery and equipment, Asian Development Bank credit as well as a subsidy has been made available. In relation to fishing, subsidies are available for the purchase of boats.

### 2. Special low interest loans

Loans at low interest rates and on special terms are available under certain conditions for the construction of houses. The Department of National Housing is responsible for granting these loans, but lower rates of interest for housing are also available from the commercial banks and approved credit institutions.

The banking system has also been geared to promoting development and loans are given by the People's Bank and the Bank of Ceylon on special interest rates for new agricultural ventures and rural development.

### 3. Providing infrastructure in particular areas

The Mahaweli Project is being undertaken by the Government and would provide irrigation facilities for the whole Dry Zone Area. This is a massive project on which work is being expedited, as it would provide the infrastructure for the agricultural development of millions of acres.

A large-scale housing programme is being planned by the Ministry of Housing with the proposal to set up a National Housing Authority and an Urban Development Authority.

A rural electrification scheme is also underway to provide the basic infrastructure for development in certain rural areas.

### 4. Others

The free trade zone proposed in an area north of Colombo is expected to be the central lever for economic development and the creation of new employment opportunities.

## E. EVALUTATION

The broad objectives of policy as outlined by the new Government in Sri Lanka in the first Budget include the promotion of growth, development and employment, the liberalisation of controls with a change to the free operation of the market mechanism and the maintenance of social justice.

The broad strategy to implement this would involve action in a number of fields such as a crash employment programme, liberalisation of imports, unification of foreign exchange rates, relaxation of price controls, reduction in unnecessary subsidies, and other measures to increase the flow of internal financial resources and foreign capital from abroad.

The cut-back on subsidies is a bold move which would be beneficial in the long run, particularly in view of the increasing expenditure in view of population increases. The immediate liberalization of imports and foreign exchange controls is a radical break from the old policy, but its impact on balance-of-payments problems and domestic industries which were protected in the past would have to be closely watched. It may be desirable to use the system of import duties more effectively in the future for relieving pressures on the balance of payments, protecting viable industries and obtaining further redistribution in favour of the lower income groups. On the other hand, the unification of the exchange rates and the liberalisation of controls would improve the competitiveness of such sectors of the economy which would be exposed to foreign competition.

The higher the rate of growth, the more employment and the larger flow of goods and services will be available for distribution. After the abolition of an important part of the rationing system, the desired degree of equity must be ensured mainly by the system of taxes, subsidies and other transfers which can be used for redistributive purposes. The dilemma in Sri Lanka with its scarce resources at present is to evolve a proper mix between social welfare and social justice on the one hand, and economic development and growth on the other, between consumption and subsidies, and savings and investment.

## LIST OF TAX TREATIES

**Concerning comprehensive double taxation treaties on income/capital**

**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Denmark | income, capital | February 16, 1963 | Danish, English and Sinhala | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 107<br>Treaty Series, Vol. 486, p. 286 |
| German Federal Republic | income, capital | July 4, 1962 | German, English and Sinhala | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 99 |
| India | income | September 10, 1956 | English | AP treaties<br>VII UN 127 |
| Japan | income | December 12, 1967 | Japanese, English and Sinhala | AP treaties<br>24 BULL 1970 Supplement B 1970<br>Treaty Series, Vol. 683, p. 91 |
| Malaysia | income | September 16, 1972 | Bahasa, Malay, Sinhala and English | AP treaties |
| Norway | income, capital | June 11, 1964 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 145 |
| Pakistan | income, capital | May 19, 1969 | English and Sinhala | AP treaties<br>IX UN A(1) 276 |
| Sweden | income, capital | May 18, 1957 | English | AP treaties<br>IX UN A(1) 4 |

**Abbreviations:**

| | |
|---|---|
| AP treaties | = Taxes and Investment in Asia and the Pacific. Part treaties. |
| SUPP.SER. Section C | = Supplementary Service to European Taxation, Section C. |
| BULL | = Bulletin for International Fiscal Documentation. |
| Treaty Series | = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French as the case may be. |
| UN | = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes. The indication VII UN 127 means: United Nations, Volume VII, page 127. |

# CONFERENCE DIARY

## SEPTEMBER 1978

*32nd Annual Congress of I.F.A.:* I. The Taxation of Extractive Industries; II. The Differences in the Tax Treatment between Local and Foreign Investors and the Effects of International Treaties. Sydney (Australia) September 17-23 (English, French, German, Spanish).

*Management Centre Europe:* International Tax Management (seminar) (subjects include tax treatment on technology import and technology export, valuation of goods for customs duty, VAT and other purposes), Oslo (Norway), September 21 and 22 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Copenhagen (Denmark, September 25-27 (English).

## OCTOBER 1978

*Confédération Fiscale Européenne (CFE):* La Fiscalité en Europe (including: tax harmonization in Europe; taxation of investments in Europe; corporate income tax in Europe with emphasis on the impact of double taxation treaties; net worth tax in Europe; co-operation between tax consultants and other free professions). Strasbourg (France), October 13 and 14 (French, English, German).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (seminar), Brussels (Belgium), November 7-8 (English).

*Seminar Services International:* The International Contracts Symposium (The structure of this Symposium is similar to that of the International Tax Planning Symposium), Zurich (Switzerland), November 15, 16 and 17 (English, French and German).

*Seminar Services International:* The 9th Multi-choice International Tax Planning Symposium (The structure of this Symposium will be similar to that of the 6th, 7th and 8th International Tax Planning Symposiums held respectively in Montreux (1977), Amsterdam (1977) and Zurich 1978)), Amsterdam (Netherlands), November 22, 23 and 24 (English, French and German).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## DECEMBER 1978

*Management Centre Europe:* Multinational Compensation (including legal tax and accounting variations and their impact on financial appraisal of benefit decisions) (Round Table), Brussels (Belgium, December 4-6 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

**FOR FURTHER INFORMATION PLEASE WRITE TO:**

Bureau van de Nederlandse Federatie van Belastingconsulenten (Bureau of The Netherlands Federation of Tax Consultants) Wassenaarseweg 20, 2596 CH Den Haag (Netherlands).

Deutsche Steuerjuristische Gesellschaft e.V.: Classen-Kappelmann-Str. 24, 5000 Köln 41 (German Federal Republic).

Euroforum: Keizersgracht 534, Amsterdam (Netherlands).

Fenedex (Federation for the Netherlands Export): Bezuidenhoutseweg 76a, 2509 LK Den Haag (Netherlands).

Financial Times Ltd. Conference Organisation: Bracken House, 10 Cannon Street, London EC4P 4BY (U.K.).

Inter-American Centre of Tax Administrators: Apartado 215, Panamá 1 (Panama).

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

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

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

Seminar Services International: Promotion Manager, Institute for International Research Ltd., 70, Warren Street, London WIP 5PA (U.K.).

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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.*

## AFRICA

### SURVEYS OF AFRICAN ECONOMIES

Volume 7: Algeria, Mali, Morocco and Tunisia. Washington, International Monetary Fund, 1977. 374 pp., $ 5.-.
The economic and financial data relate to the period 1970-74. Reference to taxation is found in the part dealing with the revenue structure. (B. 10.930)

## ASIA

### DISTRIBUTION IN ASIA/PACIFIC'S DEVELOPING MARKETS

Prepared and published by Business International Asia/Pacific, Ltd., Hong Kong, March 1978. 201 pp.
Research report designed to inform marketing executives of the many opportunities and pitfalls, peculiarities and differences in Asian and Pacific markets and to provide a basis upon which to build a distribution system suitable for the region and its many countries. (B. 51.013)

## BRAZIL

### AUSLANDSINVESTITIONEN IN BRASILIEN

Rechtsgrundlagen und Erfahrungen. Zweite aktualisierte und erweiterte Auflage. By Hans Jolowicz. Hamburg, Institut für Ibero-amerika-Kunde, 1977. Private Auslandsinvestitionen in Lateinamerika, No. 6. 444 pp.
Second revised and extended publication on foreign investments in Brazil, basic legal aspects and practical experience. It includes the basic law, capital markets. (B. 15.784)

## DENMARK

### EJENDOMSSALG 2. HALVÅR 1977

Udarbejdet af Statsskattedirektoratet Vurderingsafdelingen. Copenhagen, Government Printer, 1978. 67 pp.
Statistics on the free sales of real property in the second half of 1977, thus not including e.g. auction sales, in Denmark, prepared by the Evaluation Department of the National Tax Directorate. (B. 101.136)

## EASTERN EUROPE

### TAXATION OF MULTINATIONALS IN COMMUNIST COUNTRIES

By Paul Jonas. New York, Praeger Publishers, 1978. 99 pp.
Survey on company law and fiscal law provisions with respect to foreign investment by multinational companies in Eastern European countries, with the emphasis on investment in the form of a joint venture. (B. 101.129)

## FRANCE

### L'IMPOSITION DES PLUS-VALUES

By Pierre Courtois. Paris, Librairies Techniques (LITEC), 1978. 565 pp.
Monograph explaining the capital gains tax in France. Relevant statute of the tax law is appended. (B. 101.143)

### PRECIS DE FISCALITE CADASTRE DOMAINE; PUBLICITE FONCIERE

Tomes I et II, 1978. Paris, Ministère de l'Economie et des Finances, Direction Générale des Impôts, 1978. 890 + 900 pp.
Tax handbook in two volumes comprising a brief explanation of the taxes levied in France as of March 1, 1978 administered by the General Direction of Taxes of the Ministry of Economics and Finance. (B. 101.132/133)

## GERMAN FEDERAL REPUBLIC

### DIE BESTEUERUNG DES WERTZUWACHSES

Ein theoretischer Ansatz im Rahmen der Einkommensbesteuerung. By Otto Ebnet. Baden-Baden, Nomos Verlagsgesellschaft, 1978. Schriften zur öffentlichen Verwaltung und öffentlichen Wirtschaft, Band 31. 237 pp., DM 74.-.
Book containing a theoretical discussion on the tax treatment of realized capital gains within the scope of the current German income tax system which is — in the author's view — inconsistent. Therefore, the author also gives proposals for an amendment concerning the taxation of capital gains in Germany. (B. 101.115)

### BESTEUERUNG VON AUSLANDSBEZIEHUNGEN

By Karl-Heinz Baranowski. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1978. 488 pp., DM 75.-.
Handbook providing a detailed comment on the various tax aspects in the case of foreign relations, such as obligations of the taxpayers, tax liability of residents and non-residents, unilateral relief from double taxation, tax treaties concluded by Germany, valuation of shares in foreign companies, the foreign tax law, the foreign investment law, the developing countries tax law, etc. An extensive index is appended. (B. 101.112)

### BETRIEBSAUFSPALTUNG IM STEUERRECHT

By Helmar Fichtelmann. Cologne, Peter Deubner Verlag, 1978. 55 pp., DM 19.80.
Study which represents a more practical approach to the "Be-

triebsaufspaltung" (splitting of an enterprise into one company which possesses the fixed assets and another company which runs the current activities). It is mainly based upon the decisions of the West German Supreme Tax Court. (B. 101.111)

### EFFIZIENZ DER INDIREKTEN STEUERLICHEN FORSCHUNGSFÖRDERUNG

By Karl Ch. Röthlingshöfer and Rolf-Ulrich Sprenger. Berlin, Duncker & Humblot, 1977. Schriftenreihe des IFO-Instituts für Wirtschaftsforschung, No. 92. 124 pp., DM 48.-.
This book represents the result of a thorough study on the efficiency of indirect tax measures supporting research and development; it was made on request of the Federal Minister of Research and Technology in 1975. (B. 101.116)

### KÖRPERSCHAFTSTEUER

By Wolf-Dieter Schöne. Bonn, Stollfuss Verlag, 1978. Stollfuss Studienbücher für Wirtschaft und Verwaltung, Band 14. 112 pp., DM 15.90.
This book provides an introduction to the relevant aspects of the new West German Corporate Income Tax Law. (B. 101.110)

### MITUNTERNEHMERSCHAFTEN MIT BESCHRÄNKTER HAFTUNG — NATIONAL UND INTERNATIONAL

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This book provides a survey on co-partnerships with limited liability in the Federal Republic of Germany as well as in several European countries, the U.S.A. and Canada. It refers to a broad variety of problems involved, e.g. as regards international co-partnerships. (B. 101.114/207)

### STEUERRECHT UND WIRTSCHAFTSORDNUNG

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This book is concerned with the principles of taxation, taking into consideration recent developments in the Federal Republic of Germany. (B. 101.113)

### STEUERSTRAFRECHT

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Second, completely revised edition of a handbook explaining the penalties and procedures in case of infringement of tax laws. The relevant texts of the laws pertaining thereto are appended. Material is up to date as per January 1, 1978. (B. 101.144)

### STILLE GESELLSCHAFT UND UNTERBETEILIGUNG

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Published text of the Declaration and Decisions by the Governments of OECD member countries at the Meeting of the OECD Council at Ministerial level (June 21-22, 1976) to extend co-operation among member countries in the area of international investment and multinational enterprises. Also available in the French language. (B. 101.126)

### TRANSFER OF TECHNOLOGY BY MULTINATIONAL CORPORATIONS

Volume I: A synthesis and country case study. Edited by Dimitri Germidis. Paris, Development Centre of the Organisation for Economic Co-operation and Development, 1977. 310 pp., Fr.Frs. 54.-.
Study carried out by local researchers and other specialists under the sponsorship of the Development Centre to examine the various aspects of transfer of technology by 20 multinational corporations in 12 countries of verying levels of development, economic structure, size and geographical location, namely Argentina, Brazil, Greece, India, Ivory Coast, Kenya, Mexico, Morocco, Peru, Philippines, Spain and Venezuela. Volume I contains only the country case studies, the other materials are published in Volume II. (B. 101.119)

### YEARBOOK OF INTERNATIONAL TRADE STATISTICS 1976

Volume I: Trade by country. New York, United Nations, 1977. 968 pp.
Twenty-fifth edition of Volume I of the Yearbook of International Trade Statistics provides basic information for individual countries' external trade performances in terms of the overall trends in current value as well as in volume and price, the importance of trading partners and of individual commodities imported and exported. It is published in two volumes. (B. 101.134)

## JAPAN

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## LATIN AMERICA

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The study examines the tax position of investors in certain industrial countries who wish to carry out contracts or participate in manufacturing enterprises in important Middle East countries. (B. 50.973/937A)

### TRADE AND INVESTMENT IN THE MIDDLE EAST

By Rodney Wilson. London, The Macmillan Press, Ltd., 1977. 152 pp., £ 7.95.
Study providing an exposition of trade and investment opportunities in the Middle East and evaluations of the Arab Common Market, the role of bodies like the Kuwait Fund for Arab Economic Development and the issue of oil revenue recycling. (B. 51.000)

## THE NETHERLANDS

### DE EENZIJDIGE REGELING TER VOORKOMING VAN DUBBELE BELASTING

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Third edition. By Athony Parker. London, Jordans & Sons, Ltd., 1978. ± 700 pp., £ 32.-.
Revised edition providing interpretation of current exchange control regulations in the United Kingdom. The material covers Eurocurrency and gold markets, travel, imports, exports, merchanting and sterling securities. Exchange regulations in certain other countries in the world are appended. (B. 101.121)

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Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE

releases 15-18
Butterworth & Co., London.

TAX HAVENS ENCYCLOPAEDIA

B. Spitz
release 5
Butterworth & Co., London.

## U.S.A.

FEDERAL TAXES — REPORT BULLETIN

releases 19 and 22
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE

releases 22-24 and 27
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE REPORTS

releases 30-33
Commerce Clearing House, Inc., Chicago.

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Prentice-Hall, Inc., Englewood Cliffs.

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Commerce Clearing House, Inc., Chicago.

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U.S. TAXATION OF INTERNATIONAL OPERATIONS

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Prentice-Hall, Inc., Englewood Cliffs.

# CUMULATIVE INDEX 1978 – Nos. 1-6

# Contents

of the August/September 1978 issue



**In next issues:**

The German corporation tax reform and the revision of double tax treaties
— by *Dr. Theodor Faist*

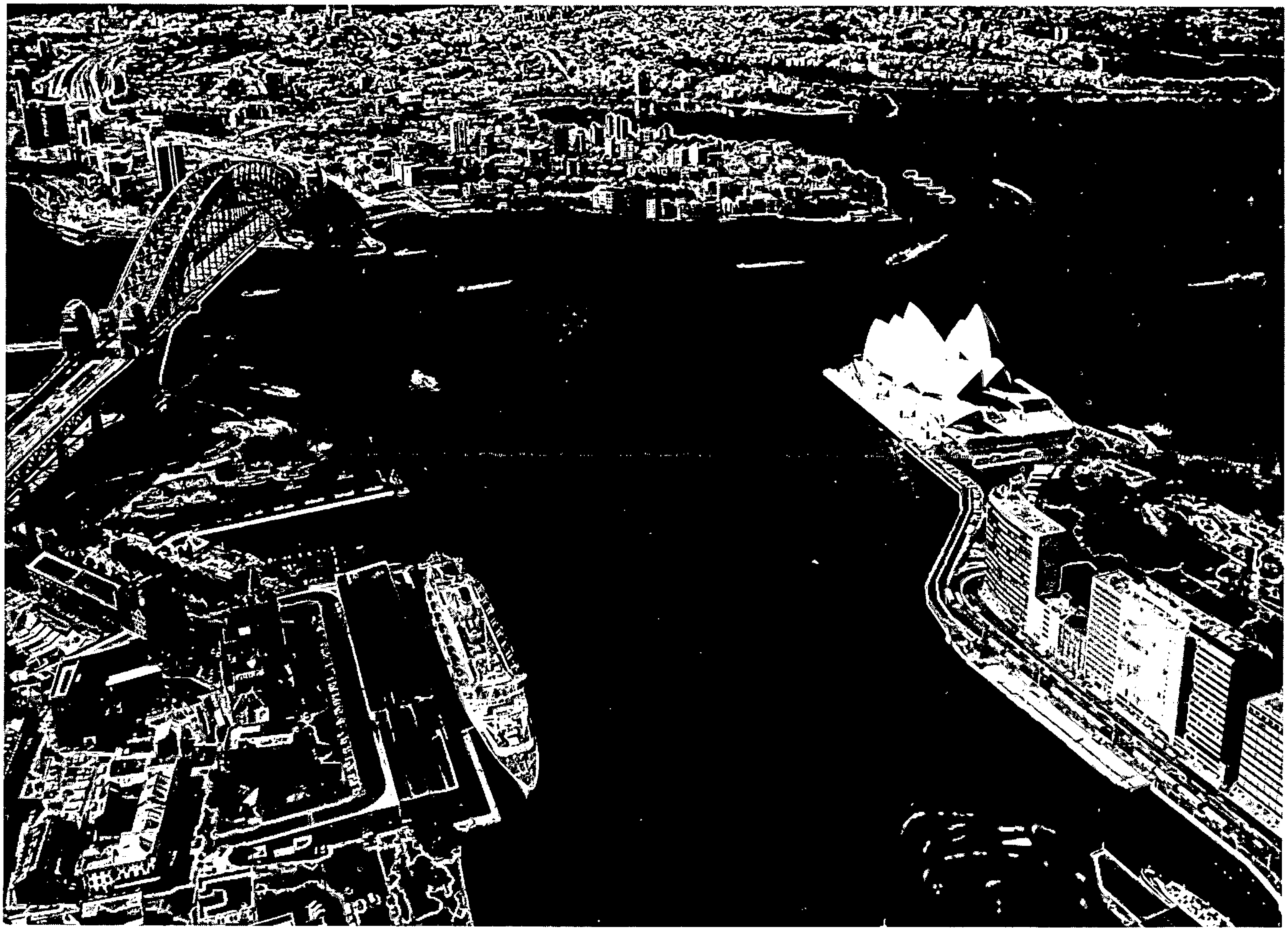
Compensation of expatriates transferred to Brazil
— by *Aleksas Juocys*

Review of CIET's training activities
— by *Prof. Pedro Massone*

Current status of studies and work on tax treaties; LAFTA and Andean Pact
— by *Ramón Valdés Costa*

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

# 32nd International Congress of IFA (Sydney)



*North Sydney with the Harbour Bridge on the left and the International Shipping Terminal and the Opera House in the foreground*

**(Photograph by John Tanner — by courtesy of the Australian Information Service, Australian Embassy in The Netherlands)**

XXXIInd CONGRESS

*Subjet I*

Taxation of the extractive industries

*Subject II*

Differences in tax treatment between local and foreign investors and effects of international treaties

XXXIIe CONGRES

*Sujet I*

l'Imposition des industries extractives

*Sujet II*

Différences dans le traitement fiscal réservé aux investisseurs nationaux et étrangers et répercussions des traités internationaux

XXXIIer KONGRESS

*Thema I*

Besteuerung der industriellen Gewinnung von Bodenschätzen

*Thema II*

Unterschiede in der steuerlichen Behandlung inländischer und ausländischer Investoren und die Auswirkungen internationaler Abkommen

# Editorial

# Taxation and Development Policy

This could have been the title for the 32nd Congress of the International Fiscal Association (I.F.A.), which Sydney will host in September of this year. It is the first to be held in the region of the Far East and the Pacific. Consequently, the chosen subjects are of special interest for the developed and developing countries of this vast area.

Economic and social development is by its nature a slow process, slower probably than many like and are willing to accept. Capital is scarce and technological skill often insufficient to exploit the wealth of natural resources and to use the innate intelligence of the local population whose rich religious and cultural background greatly differ from that of the Western world. Realistic government policies take account of these factual situations when formulating conditions for foreign investment and intra-regional and international cooperation and setting up relationships with investors from industrialised countries.

In all this, taxation plays a dominating role. The exploitation of mineral resources requires a careful and balanced tax treatment as vast transfers of capital and technology are involved.
Congress subject number one is devoted to the consequent tax problems. The second subject discusses the more general tax treatment of non-residents which poses various delicate problems. The basis for discussion of both these subjects is the general and the numerous national reports published in the *Cahiers du Droit International.*

A special panel discussion between distinguished experts in the field will deal with the subject of *Tax Structure and Fiscal Policy in the Pacific Region.* Underlying material is provided by papers from countries within the area published in this and two preceding issues of the *Bulletin*.

Intraregional cooperation is progressing. Reports on ASEAN and ESCAP (U.N. Economic and Social Commission for Asia and the Pacific) activities will continue to appear in the *Bulletin*. A unique opportunity for ESCAP and Congress members to exchange views and experiences is offered in Sydney where both groups meet this year. In this connection it is not accidental that the Bureau, sponsored by ESCAP, presents the first two volumes of a large and comprehensive publication on *Taxes and Investment in Asia and the Pacific.*

An important Congress on crucial subjects — this is what I.F.A.'s 32nd meeting promises to be. In order to provide the guests with backgroud information about the host country, Australia's Treasurer, the Hon. J. Howard, MP, made available for this issue a brief survey of his views on the economic prospects of his country. This is followed by an article on Australia's tax system and its particular federal features, by Mr. G. Thimmaiah who made a through study of the Australian tax system. Preceding the four country papers on the Tax Structure and Fiscal Policy in Australia, Indonesia, the Philippines and Western Samoa is the special article which the West German Minister of Economic Cooperation, Mr. R. Offergeld, kindly accepted to contribute for this special issue. Apart from all this, readers may be interested in developments in Eastern Europe in the area of double taxation, and in the largest oil producing country of Africa: Nigeria.

J. van Hoorn Jr.

# The Performance of the Australian Economy in 1978*

**by John Winston Howard**

*John Howard was born at Earlwood, New South Wales on 26th July, 1939.*

*Mr. Howard matriculated to Sydney University in 1957 and graduated in 1961 with a Bachelor of Laws. He was admitted as a solicitor of the New South Wales Supreme Court in July 1962 and before his election to Federal Parliament was a partner in a Sydney firm of solicitors.*

*Mr. Howard is a former State Vice-President of the Liberal Party and has served on the New South Wales Executive of the Party for a period of ten years. He is a former Chairman of the New South Wales Young Liberals.*

*In May, 1974, Mr. Howard was elected to the Sydney suburban seat of Bennelong. In March, 1975, he became Shadow Minister for Consumer Affairs and Commerce.*

*On 22nd December, 1975, Mr. Howard was appointed Minister for Business and Consumer Affairs. As part of this portfolio, the Minister was responsible for the Trade Practices Commission, the Industries Assistance Commission and the Prices Justification Tribunal.*

*During his tenure of this Ministry, Mr. Howard commenced several major reforms, including proposals for a national approach to corporate regulation. A major review of Trade Practices legislation was also undertaken.*

*In May, 1977, Mr. Howard was given the further appointment of Minister Assisting the Prime Minister.*

*On 17th July, 1977, Mr. Howard was appointed Minister for Special Trade Negotiations, while remaining also Minister Assisting the Prime Minister. This new portfolio was primarily involved with the development of Australis's trading relations with the European Communities and involved the Minister in high level trade negotiations with the Commission of the Communities and with the Governments of the individual member countries.*

*On 19th November, 1977, Mr. Howard was appointed Treasurer. He was reappointed to this position in the new Fraser Government after the elections of December, 1977.*

My purpose today is to attempt a brief assessment of how I see the Australian economy this year.

In doing so I express the very firm view that our basic economic performance is steadily improving notwithstanding a number of adverse factors and indicators which in any objective assessment must be freely acknowledged.

I do not intend to exaggerate the extent to which the Australian economy has improved over the past two years.

Nor, however, will I allow to be sold short the very great progress which has been made during that period in correcting fundamental faults in our economy.

No examination of economic prospects in Australia can occur without acknowledging the relevance of world economic trends.

Whilst growth in most overseas countries is still relatively subdued by continued high inflation and adverse inflationary expectations, overseas economic activity in 1978 is expected to increase at a moderate rate similar to that experienced in 1977.

From the time it took office the Government saw the defeat of inflation as its main economic objective.

This goal has been resolutely pursued during the past two years.

Our annual inflation rate is now unambiguously below 10 percent — having fallen from a level 4-5 percentage points higher in December 1975.

Inflation in Australia will fall further in 1978.

.iowever, the real progress made on the inflation front should not induce any sense of complacency.

Wilst our rate of inflation broadly matches the OECD average it is still higher than a number of our trading partners.

Quite clearly we must continue to bear down on inflation and not squander the hard-won gains of the past two years through a premature relaxation of the strategy which has produced those gains. Seven months after the Budget of 1977 if can fairly be said that its predictions about inflation have been more than realised.

Wilst other economic indicators remain varied a quick look at the key elements of the economic outlook for 1977/78 sketched out in the Budget papers last August shows that the economy seems to be performing at least as well as expected at that time and in some important respects substantially better.

* Speech to the Australian Financial Review Luncheon at the Hilton Hotel, Sydney, Monday, 20 March 1978.

JOHN WINSTON HOWARD

Demand has been expanding.

Business capital investment picked up strongly in the second half of 1977 — increasing by 12 percent in seasonally adjusted terms compared with the first half of the year.

Real non-farm product rose by 1.2 percent in the September quarter and it would appear that the Budget projection for this aggregate may prove to have been on the conservative side.

Despite the steady improvement in these areas it must nevertheless be said that unemployment remains a major item of concern to the Government; this is a subject to which I shall return later.

Last month saw the introduction of the new standard rate taxation system which this calendar year will add approximately $1,000 million of additional spending capacity to Australian consumers.

Not only are these taxation reductions a major earnest of the Government's policy of progressively lightening the personal tax burden; they should also be seen in the context of a direct stimulus to activity in the Australian economy.

The full context of the February taxation changes are seen when one recalls the Budget speech of my predecessor which stated:

> "... (The Budget) will be maintaining maximum pressure on inflation in the first half of the financial year. In the second half of the financial year as the results of these policies bear their fruit, the budget will add a stimulus to activity through the large increase in disposable incomes flowing from tax reductions associated with changes to the personal income tax system. . ."

It is self evident that the application of those policies have borne fruit in terms of reduced inflation thus setting the appropriate scene for the stimulus of activity through the taxation reductions.

The revisions to inflationary expectations referred to earlier are already being reflected in the market place; a sustainable reduction in interest rates has occurred.

Yields on long-term government securities have fallen by about 1¼ percent since the Budget and there have been significant reductions in yields on other securities.

Some bank deposit rates, and rates on lending for housing, have been reduced by ½ percent recently, and similar reductions are flowing through to competitive financial institutions.

More generally, private sector rates across a wide spectrum are steadily responding to those reductions in official yields.

This has taken place in the context of what has been a satisfactory rate of funding of the Budget deficit by way of private non-bank take-up of government securities.

The rate of growth of the monetary aggregates — particularly M3— over the past seven months has been more subdued than that envisaged at the time of the Budget.

When allowance is made for the lower than expected rate of inflation, changed arrangements for company tax payments and some hesitancy of private capital inflow, the performance of the monetary aggregates thus far in this financial year is seen in better perspective.

There will, of course, be the usual seasonal run down in liquidity over the next few months.

The Prime Minister and I have both recently indicated the determination of the Government to avoid any suggestion of a credit squeeze during this period.

The Reserve Bank, which has a wide variety of instruments available to it, will closely monitor developments with a view to assisting the market in the orderly negotiation of the run down.

The Government remains in regular contact with the Reserve Bank and will itself closely watch the situation over the months ahead.

The Government has recently been informed by the Reserve Bank that trading banks have been told that during the run down period they can in response to genuine demands for funds raise their rates of new lending beyond the levels currently permitted.

Over the past two years monetary management has been flexible and by any standard, very successful.

We are confident it will remain so during the period ahead.

The November, 1976 devaluation and the steady reduction in Australia's inflation rate have significantly improved the competitiveness of Australian producers.

A greater degree of import replacement is occurring; in fact, since the March quarter last year the volume of imports has been falling and is now running considerably below pre-devaluation levels.

The current account strengthened markedly in the last half of 1977.

In my statement of 5 February I indicated that, pending the resumption of a more normal rate of private capital inflow, the Government would finance the current account deficit by undertaking such overseas borrowings on official account as proved necessary to supplement Australia's reserves and to support the Australian dollar.

That announcement has been generally welcomed as an indication of the Government's resolve to operate external policy in a manner consistent with domestic economic objectives.

Last week I indicated our plans for the latest in this ongoing series of borrowings — a raising in the order of US$300 million in Europe to be arranged on our behalf by the Deutsche Bank.

The economic achievements of the Government during the past two years, and the growing evidence that the Government's economic strategy will produce further results during 1978, are receiving increasing recognition in the overseas business and financial community.

I have already indicated that the budget deficit for this year will be higher than that projected at the time of the Budget last August.

As a direct response to pressing need, the Government has quite consciously added to the estimate of prospective outlays for the year. In particular, I refer to the additional assistance to the beef industry and assistance to alleviate the serious consequences of the continuing drought.

These situations of need, which arose after the Budget, required decisive action on the part of the Government and we took that action.

The larger revisions of the prospective budget deficit for this fiscal year have arisen on the revenue side.

Receipts from customs duty in particular are now expected to be well down on the Budget estimate.

We have revised downwards expected imports for the year as a whole, in part because the process of import replacement is proceeding a little quicker than we expected at the time of framing the Budget.

Hence while we are concerned that customs duty will this year represent a smaller source of revenue than we had hoped, we are encouraged by the extent to which the devaluation decision of late 1976 is having the desired effect on the level of imports.

The other major area of revision on the revenue side has been PAYE refunds. This reflects the considerable uncertainty surrounding this estimate following the first full year in which the "Hayden" rebate scheme took effect.

Apart from these two specific items on the revenue side I wish to draw particular attention to the significance of the lower rate of inflation than we anticipated at the time the Budget was framed; while this has not yet had much effect on the budgetary out-turn, it may be expected to do so in coming months.

That is, to the extent that we have been more successful in our fight against inflation than we had thought likely at the time of drafting the Budget, the deficit in prospect for the current year will tend to be somewhat larger.

In due course lower inflation will lead to a smaller deficit both via strengthened activity and lower spending for those outlays which are indexed to prices or wages; but in the short-run the tendency is the other way.

I should, however, emphasise that expenditure restraint remains a central element of our economic stategy and its importance to the Government was reaffirmed shortly after the Government's re-election.

Our commitment to continued expenditure restraint and a sensible monetary policy are allied to our determination to continue pursuing a disciplined wages policy.

Not only is a disciplined wages policy directly relevant to the restoration of an adequate profit share towards the level needed to sustain a fully prosperous private sector, but it is also fundamental to a sustained mitigation of the unemployment problem.

I now wish to say something about the Government's attitude towards unemployment, for two reasons.

Firstly, there remains an innuendo — which in at least one quarter this morning has burgeoned to an accusation of malign neglect — that the Government has done insufficient to reduce the high level of unemployment; the clear implication is that the Government sees high unemployment as serving its anti-inflationary strategy.

Secondly, there is still insufficient understanding in the community as to the real cause of our present employment and what is required to achieve a lasting reduction.

No charge can be more false than that this Government has used unemployment as an economic weapon.

Not only does this charge ignore the practical concern demonstrated by the Government towards the difficulties of those out of work but it also ignores the very simple fact that high unemployment does not and never can serve the Government's economic objectives.

High unemployment is a cause of consumer caution and hesitancy. It also directly affects the Budget.

A lasting reduction in the unemployment we now experience can only result from a combination of policies which on a general level produce economic recovery — thus improving the climate for job seekers — and on a more specific level are designed to improve the versatility, mobility and skills of our workforce.

Concern for the problem of unemployment must not blind us to its fundamental causes and realistic solutions.

It remains undeniably true that accelerating inflation, collapse of private sector confidence and the wages explosion of several years ago were the prime causes of our present high level of unemployment.

Those who doubt that proposition should note that in the two year period between November 1973 and November 1975, unemployment as measured by the quarterly ABS survey rose from 105,000 to 275,000 — an increase of 160 percent.

By contrast, the increase between November 1975 and November 1977, was some 40,000 or 14 percent.

It is thus clear that over 80 percent of the total rise in unemployment over the last four years took place before November 1975, and took place at a time when Government pursued permissive economic policies.

This Government remains firmly of the view that in present circumstances high inflation and high unemployment are inextricably linked and that a lasting reduction in unemployment cannot be purchased through a relaxation in the fight against inflation. All our recent economic history points to the opposite result of such a change in policy.

It is in this belief and against this background that the present Government has given such priority to fighting inflation and has attempted to bring wages, productivity and profits into balance once again.

Sustained progress in reducing unemployment cannot be won until, through the control of inflation, sustainable growth in demand and output is fostered and the distortion between real wages and productivity is removed so that employers can once again afford to take on additional labour.

It is for these reasons that the Government has placed such great stress on wages policy over the past few years.

Whilst I would be less than frank if I did not express disappointment at the failure of the Conciliation and Arbitration Commission at the last National Wage Case to seize the opportunity so clearly afforded it of granting no increase at all, it must nonetheless be said that the decision in that case represented in relative terms the most helpful decision given by the Commission during the past two years.

During the past two years the official representatives of the trade union movement of Australia have displayed at national wage hearings a zealous concern for the apparent interests of those in work but a total indifference to the real interests of those out of work.

To put it another way, if full wage indexation had been granted by the Commission at every hearing over the past two years — that is, if the trade union submissions had met with total success — then not only would our current level of inflation be higher but so would our current level of unemployment.

Our general policies to encourage economic recovery are the key to our strategy on unemployment, but as I mentioned earlier, these can be supplemented by more specific policies aimed to develop the skills of our workforce and to improve their relevance to current economic demands.

No serious analysis of the problem of unemployment in Australia can ignore the fact that there are structural changes occurring throughout most of the western industrialised world. These changes have a profound effect on employmend demands, and all of you will be familiar with the paradox of a high rate of unemployment existing side by side with industries unable to secure skilled workers. No solution to the problem of unemployment will be anywhere near complete unless these issues are serriously and adequately addressed.

During the past two years this Government placed great stress on training schemes as a method not only of alleviating unemployment but also a method of more adequately equipping the Australian workforce to respond to change in Australian industry.

Since its election the Government has considerably broadened the eligibility criteria of the NEAT Scheme, has introduced the employment plan for unemployed youth (EPUY) which is specifically designed to remedy the deficiency in basic skills which is so apparent amongst some sections of the young school leavers and has greatly improved the facilities available for apprenticeship training.

In recognition of the link between our education system and the future demands of the labour market the Government last year established an inquiry under Professor Williams to inquire into education and training.

The results of this inquiry should be available this year and will make a major contribution towards answering the question of whether our education system is sufficiently serving the requirements of this country's labour market.

Les us acknowledge that there is a common concern in the community about unemployment — let us recognise that our differences are not about the level of concern but rather the methods required to solve the problem.

To summarise, Mr. Chairman, the Government views 1978 with optimism.

It remains fundamentally committed to an anti-inflationary strategy.

It believes this strategy has remedied basic weaknesses in the Australian economy and it acknowledges that much remains to be done to achieve the full economic recovery to which we all aspire.

Mr. Chairman, all of you here today would know the Australian economy has seen a lot in the last five years.

Slightly more than two years ago this Government took the firm decision that recovery could only occur through the persistent pursuit of an anti-inflationary strategy which laid the basis of lasting recovery.

The results of that strategy are now becoming apparent.

Consumer and business confidence is returning.

We did not underestimate the difficulties of following a strategy which was light on short term appeal but in the long run is the only basis upon which a lasting recovery could be built.

We have no regrets at having chosen that strategy as we believe it is now bearing fruit.

Our task for the remainder of 1978 is to build upon the gains of the past two years.

In that task we all have a role to play.

# CONFERENCE DIARY

## SEPTEMBER 1978

*Management Centre Europe:* International Tax Management (seminar) (subjects include tax treatment on technology import and technology export, valuation of goods for customs duty, VAT and other purposes), Oslo (Norway), September 21 and 22 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Brussels (Belgium), September 20-22 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including tax in international operations) (Seminar), Copenhagen (Denmark), September 25-27 (English).

## OCTOBER 1978

*Business International Institute:* Seminar on International Finance (including: Taxation of international financial operations), Port Chester, New York (U.S.A.) October 3-6 (English).

*Confédération Fiscale Européenne (CFE):* La Fiscalité en Europe (including: tax harmonization in Europe; taxation of investments in Europe; corporate income tax in Europe with emphasis on the impact of double taxation treaties; net worth tax in Europe; co-operation between tax consultants and other free professions). Strasbourg (France), October 13 and 14 (French, English, German).

*Institute for International Research:* The 1978 Corporate Finance Conference (subjects include: tax problems in foreign currency dealing, international transfer pricing problems and policies, evaluating international tax at the business decision level), London (United Kingdom), October 25-27 (English).

## NOVEMBER 1978

*Management Centre Europe:* Tax management in a multinational environment (seminar), Brussels (Belgium), November 7-8 (English).

*Seminar Services International:* The International Contracts Symposium (The structure of this Symposium is similar to that of the International Tax Planning Symposium), Zurich (Switzerland), November 15, 16 and 17 (English, French and German).

*Seminar Services International:* The 9th Multi-choice International Tax Planning Symposium (The structure of this Symposium will be similar to that of the 6th, 7th and 8th International Tax Planning Symposiums held respectively in Montreux (1977), Amsterdam (1977) and Zurich 1978)), Amsterdam (Netherlands), November 22, 23 and 24 (English, French and German).

*Management Centre Europe:* International Tax Management Seminar, Brussels (Belgium), November 27-29 (English).

## DECEMBER 1978

*Management Centre Europe:* Multinational Compensation (including legal tax and accounting variations and their impact on financial appraisal of benefit decisions) (Round Table), Brussels (Belgium, December 4-6 (English).

## MARCH 1979

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

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

## FEBRUARY 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business International Institute: One Dag Hammarskjold Plaza, New York, N.Y. 10017 (U.S.A.)

Business Perspectives: 11 Alexander Place, London, SW 7 2 SG. Tel. 01-589-3197. Telex: 917036.

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

Generalsekretariat C.F.E.: Postfach 1370, D-5300 Bonn 1, Bundesrepublik Deutschland.

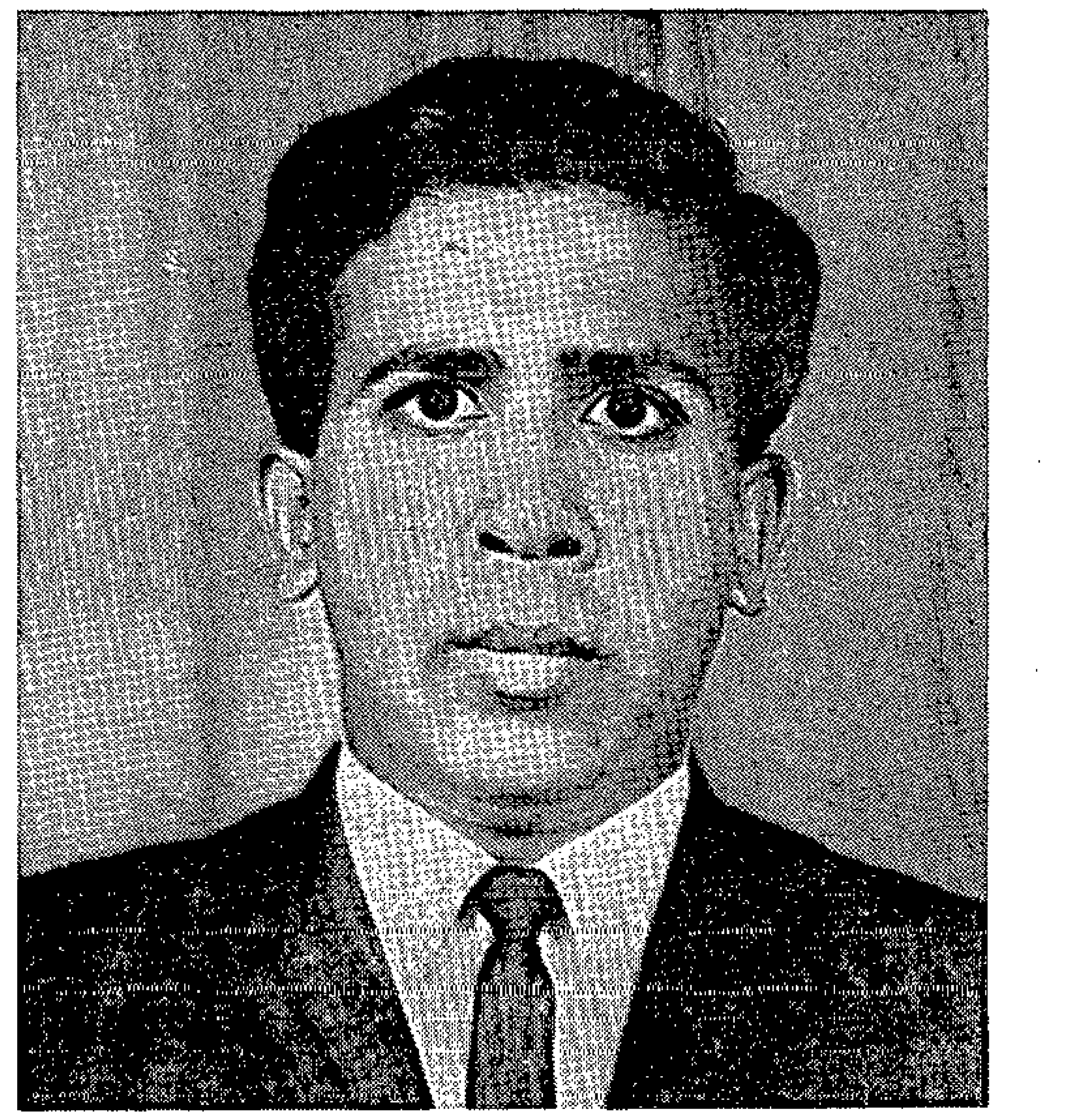
Institute for International Research: 70 Warren Street, London WIP 5PA, United Kingdom.

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

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

Seminar Services International: Promotion Manager, Institute for International Research Ltd., 70, Warren Street, London WIP 5PA (U.K.).

# Recent Deve opments 'n Australian Federal Fiscal Arrangements



by G.Thimmaiah*

There can be little doubt that the Australian federal fiscal system as it is presently operating differs substantially from the system which was originally contemplated. Though it evolved gradually during the first seventy years of its operation, the subsequent developments heralded a period of transition. This is evident from certain changes which have been introduced during the 1970's.

## I. INTRODUCTION: THE GRANTS COMMISSION

The recent changes in the Australian federal fiscal arrangements were mainly the outcome of the changes in the political Parties in power at the national level. In the December 1972 federal elections the Labor Party was elected and after its long period of absence from power, returned with a big bang in Canberra. Even before this political victory the Labour Party had announced, in its 1971 and 1972 Federal Conferences, many far-reaching changes which it would introduce in the federal fiscal system of Australia if it were elected.[1] As soon as the Labour Party came to power it wanted to keep its promises and, accordingly, the former Prime Minister Whitlam introduced certain changes in the federal fiscal system. But some of these changes were resented by the then Opposition Party and, after the fall of the Labour Government in the December 1975 elections, the Liberal-Country Party Coalition Government headed by Mr. Fraser announced its Federalism Policy which included certain reversals of the changes introduced by the Labour Government. Thus, some of the changes in the Australian federal fiscal system during 1970's may be regarded as resulting from the fight between the Labour Party and the Liberal-Country Party over the basic principles of federalism, the Labour Party proposing to strengthen the hands of the Australian[2] (Commonwealth) Government and the Liberal-Country Coalition Party opposing that move and proposing to give a say to the State Governments in any such changes without giving up the idea of strengthening the hands of the Commonwealth Government in decision-making at the national level.

An important change which the Labour Government introduced in the Australian federal fiscal system was with regard to the scope and function of the Commonwealth Grants Commission. The Liberal-Country Party Coalition Government tried deliberately in the 1960's to eliminate the Commonwealth Grants Commission gradually by expanding the specific purpose grants and increasing the financial assistance grants, thereby reducing the need for special grants. For instance, the Commonwealth Government persuaded Western Australia in 1968 and Queensland in 1970 to abstain from applying for special grants by making good the loss by specific purpose grants. This attempt was not totally successful. As I have observed elsewhere[3] so long as the horizontal federal fiscal imbalance exists in the Australian federation, the need for unconditional grants (special grants) will persist and hence the need for an expert body like the Commonwealth Grants Commission will continue to exist. However, the Commonwealth Government led by Mr. Whitlam should be credited with increasing the life of the Commonwealth Grants

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* The author is Senior Fellow in Economics, Institute for Social and Economic Change, Bangalore, India. In 1971 he was awarded a Post-doctoral Fellowship by the University of Queensland, Brisbane (Australia) to study Australian fiscal federalism. His study was published in 1976 in India under the title "Federal Fiscal Systems of Australia and India".

1. E.G. Whitlam, "The Future of Australian Federalism — A Labour View", in R.L. Mathews (ed), *Intergovernmental Relations in Australia*, Angus and Robertson Publishers, Sydney, 1974, pp. 295-306.
2. The Labour Party Government headed by Mr. Whitlam had changed the name of the Federal Government from "Commonwealth Government" to "Australian Government". But the Liberal-Country coalition Government headed by Mr. Fraser reversed it back to "Commonwealth Government" in 1976.
3. G. Thimmaiah, "The Changing Role of the Australian Commonwealth Grants Commission: A Reexamination", *Public Finance/Finances Publiques*, Nos. 3.4/1973, pp. 407-419.

Commission by expanding the scope of its recommendations. The Commonwealth Government repealed the *Australian Commonwealth Commission Act, 1933-57* in 1973 and enacted a new piece of legislation, the *Grants Commission Act, 1973,* which expanded the scope of the recommendations of the Commonwealth Grants Commission so as to cover the financial needs of the Local Governments also.

The new Act which came into effect on 20th September 1973, has of course continued the traditional function of the Commission, namely that of recommending special grants to the financially needy States under Section 96 of the Australian Constitution. But even here the new Act has introduced some changes. That is, Section 5 of the Grant Commission Act, 1973 specifies the principle of determining the special grants by writing into this statute the principle which was developed by the Commonwealth Grants Commission in its Third Report. Section 5 of the 1973 Act reads:

"References in this Act to the grant of special assistance to a State are references to the grant of financial assistance to a State for the purpose of making it possible for the State, by reasonable effort, to function at a standard not appreciably below the standards of other States".

The purpoose of writing this principle of determining the special grants for the claimant States [4] into the Act appears to be to focus the attention of the Commission on the need for equalising certain essential services in the States rather than equalising either revenues or expenditures as was advocated by some claimant States in Australia. Although the earlier flexibility in formulating the principle of determining special grants for the claimant States has been eliminated by this Section, it has ended all speculation about the possible interpretations of the principle enunciated by the Commission in its Third Report.

But the novelty of the 1973 Act is that it has widened the scope of the Commission's functions under Section 18 (3) so as to cover ".....(b) a matter relating to a grant of financial assistance made to a State for local financial assistance to a State for local Government purpose". Besides, the 1973 Act changed the name of the Commission from the earlier "Commonwealth Grants Commission" to simply "Grants Commission". Though this change went without comment in Australia, it was significant in that it was related to the expanded scope of the Commission under Section 18 (3) of the 1973 Act referred to above. Although the Commission was created by legislation of the Commonwealth Parliament, in a federation any such Commission should represent both the federal and the States' interests. No doubt this was done earlier in the selection of the members, and in evidences and representations made to the Commission. However, its very name suggested that the Commission represented the money-giving Commonwealth Government. Under the 1973 Act, in view of further decentralisation of the Commission's responsibilities down to the Local Governments, it was probably considered appropriate to change its name to simply "Grants Commission". However, the Liberal-Country Party Coalition Government headed by Mr. Fraser amended the Grants Commission Act of 1973 in 1976 and restored the name of the Grants Commission to the earlier "Commonwealth Grants Commission" just to satisfy the State Governments.

When the scope of the recommendations of the Commission was expanded, the Commission faced the problem of evolving an appropriate methodology for assessing the financial needs of nearly 900 Local Governments all over Australia and determining the grants for the financially needy Local Governments. The Commission's earlier method of determining the grants for the claimant States by referring to the standard States was not workable because of the large number of Local Governments in relation to the limited time at the disposal of the Commission. Though the State Governments, particularly New South Wales and Victoria, had appointed several Committees [5] to explore the financial needs of the Local Governments and one of them (New South Wales) [6] had formed its own Local Grants Commission to recommend financial assistance required from the State Government, they had not developed any methodology which could be advantageously adopted for the entire country. Therefore, it became necessary for the Commission to adopt a methodology which would be appropriate for recommending grants for both claimant States and claimant local Governments. Accordingly, the Commission turned to a more direct method of determining the grants for financially needy States. Such a direct method had been submitted by the Commonwealth Government to the Commission in its earlier submissions but had been rejected by both the Commission and the claimant States. However, the Commission decided to adopt this direct method in its Forty-First Report for the reasons mentioned above. [7]

The Commission has attempted at length to show the similarities between its old and new methods in the Forty-First Report. [8] The old method of the Commission is in its Forty-First Report in the following way:

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4. The States which submit their claims to the Commonwealth Grants Commission for special grants have come to be called Claimant States in Australia.

5. See *Report of the Commission of Inquiry into Local Government*, Victorian Government Printer, Melbourne, 1962, and *Report of the Royal Commission of Inquiry into Rating, Valuation and Local Government Finance*, New South Wales, Government Printer, Sydney, 1967.

6. In the December 1975 federal elections, the federal Opposition Parties proposed that if they won the elections (which they did), they will require all the States to establish such Commissions. This has been implemented by all the State Governments as it is made necessary for receiving financial assistance grants from the Commonwealth Government for purposes of distributing among Local Governments in each State.

7. *Grants Commission Forty-First Report 1974 on Special Assistance for States.* Australian Government Publishing Service, Canberra, 1974, p. 34. Also see *Grants Commission First Report 1974 on Financial Assistance for Local Governments*, Australian Government Publishing Service, Canberra, 1974.

8. *Grants Commission Forty-First Report*, pp. 34-37.

$$G = D_c - D_s$$
$$= (E_m + F_e - U_e - R_m + F_r - U_r) - (E_s - R_s) - G_g$$
$$= (E_m + F_e - U_e) - (R_m - F_r + U_r) - (E_s - R_s) - G_g$$

but $E_c = (E_m + F_e - U_e)$

and $R_c = (R_m - F_r + U_r)$

Therefore,

$$G_a = (E_c - R_c) - (E_s - R_s) - G_g$$
$$= (R_s - R_c) + (E_c - E_s) - G_g$$

Where:

$G_a$ = assessed special grants for a claimant State.

$D_c$ = claimant State's adjusted deficit.

$D_s$ = average per capita deficit of standard States multiplied by population of claimant State.

$E_m$ = modified expenditure of a claimant State.

$F_e$ = favourable adjustments for below-standard expenditures.

$U_e$ = unfavourable adjustments for above-standard expenditures.

$R_m$ = modified revenue of a claimant State.

$F_r$ = favourable adjustments for below-standard revenue-raising effort.

$U_r$ = unfavourable adjustments for below-standard revenue-raising effort.

$R_s$ = revenue of a claimant State assuming standard revenue-raising capacity and standard revenue-raising effort (average per capita modified revenue of standard States multiplied by claimant State's population).

$G_g$ = assessed financial needs of a claimant State met from other forms of grants from Australian Government.

$E_c$ = expenditure of a claimant State assuming claimant State's cost of providing standard services (cost to claimant State of providing standard range and quality of services).

$R_c$ = revenue of a claimant State assuming claimant State's revenue-raising capacity and standard revenue-raising effort (average of standard State's revenue effort applied to claimant State's revenue base).

Compared to this elaborate and time consuming method, the Commission's new method is short and simple. This method is summarised by the Commission in the following way:

$$G_a = (G_r + G_e - G_g)$$
$$= (R_s - R_c) + (E_c - E_s) - G_g$$

Where:

$G_g$ = assessed revenue needs of a claimant State.

$G_e$ = assessed expenditure needs of a claimant State and $G_a$, $G_g$, $R_s$, $R_c$, $E_s$, and $E_c$ are as defined above.

Thus, according to the Commsssion, the assessed special grant for a claimant State in terms of the new method is the sum of:

"........(a) its revenue needs, defined as the difference between (i) the revenue it would have raised if it had applied the average revenue effort of the Standard States (the standard revenue effort) to its own revenue base, and (ii) the revenue it would have raised, on the basis of the standard revenue effort, if its per capita revenue base (or its revenue-raising capacity) had been the same as the average revenue base of the standard States; and (b) its expenditure needs, defined as the additional costs of the claimant State of providing its population with State services of the same average range and quality as those provided for their population by the standard States". [9] This new direct method has been accepted by the claimant States as well as by the Local Governments, and the Commonwealth Government is satisfied with its acceptance.

Another change which was introduced in the 1973 Act relative to the Commonwealth Grants Commission concerns the size and composition of the Commission. Earlier, under the 1933 Act, the Commission consisted of not more than three members, one of whom was appointed as the Chairman. Both the Chairman and the members could be appointed for either part-time or full-time service. Under the 1973 Act, with the expanded scope of the recommendations of the Commission, the size of the Commission was increased to a minimum of four and a maximum of six members in addition to the Chairman. Moreover, it was stipulated that the Chairman should be appointed on a full-time basis and that members may be appointed on either a part-time or a full-time basis.

What is more, the Commission was divided into two parts: one part consisting of the Chairman and two part-time members of the presently appointed six members, and the other part consisting of the same Chairman and the remaining four full-time members. The former part of the Commission was entrusted with the task of determining the special grants for the claimant States and the latter part was entrusted with the task of determining the financial assistance for the Local Governments. This division of the personnel of the Commission was apparently too rigid and, consequently, it created in the course of time the problem of coordination in the Commission's day-to-day work. Therefore, it would be necessary to do away with this division of responsibility among the members of the Commission. In the December 1975 federal elections, the federal opposition parties had proposed to eliminate the latter part of the Commission if they won the elections. But the Liberal-Country Party Coalition Government amended the Grants Commission Act of 1973 in 1976, although it did not change the two part system of the Commission which was introduced by the Labour Government in 1973. The Commonwealth Grants Commission Act of 1976 requires the Commission to retain the two part system. The first part, consisting of the Chairman and two

9. *Grants Commission Forty-First Report*, p. 34.

part-time members, will report on special grants to the claimant States, and the second part, consisting of the same Chairman and four full-time members, will report on the financial assistance grants to the Local Governments. However, the 1976 Act has brought about some changes in the functions of the second part of the Commission. The 1976 Act has specified that the second part of the Commission should recommend the distribution of financial assistance from the Commonwealth Government among the Local Governments by taking into account the following principles:

30 percent of such financial assistance should be distributed by the State Governments among their Local Governments on a per capita basis with a weighted formula to be recommended by the second part of the Commission. The remaining 70 percent of the Commonwealth assistance must then be distributed by the State Governments on an equalisation basis on the recommendation of the State Grants Commission. Thus, responsibilities for Local Government enquiries will be transferred to the State Grants Commissions. In the February, April and June 1976 Premier Conferences, agreement was reached between the Commonwealth Government and the State Governments regarding the new arrangements for financial assistance to Local Governments. Pursuant to this agreement, an amount of 140 million dollars was provided by the Commonwealth Government to the States in 1976-77 for distribution to Local Governments on the following basis: (i) not less than 30% of the total amount for each State was to be distributed on a per capita basis, weighted as necessary so that all Local Government authorities shared the allocations. This was called element "A"; (ii) the remaining amount was to be distributed upon the recommendations of the State Grants Commissions according to the financial needs of individual Local authorities. This was called element "B". In addition, the Commonwealth Grants Commission was asked to determine the appropriate Local Government authority which will be entitled to this grant.

Thus, according to 1976 Act the Commonwealth assistance to the Local Governments will pass through the State Governments: a part of it will be allocated on a pre-determined basis and the remaining amount will be recommended by the State Grants Commissions to the Local Government authorities on an equalisation basis. The earlier power of the Commonwealth Grants Commission to distribute Commonwealth assistance directly to the Local Governments on the basis of the latters' fiscal needs has been dispensed with. Though the modifications made in 1976 Act are welcome, the earlier attempt to achieve a uniform standard of public services at the Local Government level for all of Australia has unfortunately gone to the winds under the changes introduced in 1976.

## II. THE FLUCTUANT NUMBER OF CLAIMANT STATES

The Australian federal fiscal scene has been marked by the fluctuating number of claimant States. Though in the 1960's this number was reduced to only one (Tasmania in 1969), it was the result of the deliberate efforts of the Commonwealth Government, particularly the Liberal-Country Party Coalition Government. The Commonwealth Government persuaded Western Australia and Queensland to abstain from applying for special grants by providing them substantial specific purpose grants and by making upward adjustments in the factors on the basis of which the financial assistance grants were distributed. [10]

Later, the former Prime Minister Mr. Gorton provided a massive dose of specific purpose grants to Tasmania and South Australia. However, South Australia returned to claimancy in 1970 and Queensland received a special grant in 1971-72. The Commonwealth Government, under the Prime Ministership of Mr. Whitlam, further assisted Tasmania so as to financially enable it to avoid special grants. Even so, Tasmania applied for special grants up to 1975-76.

Historically, although South Australia and Queensland did apply for special grants after some period of withdrawal, Tasmania and Western Australia were continuously claimant States. Western Australia withdrew in 1968 as a consequence of its financial improvement which partly resulted from its mineral boom. It has not applied for special grants ever since. Tasmania gave the impression of withdrawing from special grants during 1974-75 as a result of the other forms of financial assistance it received from the Australian Government. But it applied for special grants for the years 1974-75 and 1975-76. However, it ceased being a claimant State during 1976-77 when it withdrew its application for special grants. To date, Queensland has decided to continue to be a claimant State. This has certain policy implications for both the Australian States and the Commonwealth Grants Commission. Although the withdrawal of the States from the special grants during some years was a happy situation as far as the Comcomwealth Government was concerned, it was not an equally happy situation for the State Governments from the point of view of their financial autonomy. So long as horizontal federal fiscal imbalance exists in the Australian federation, the need for federal fiscal assistance will continue to exist. But the Commonwealth Government has been increasing its hold over the States' policy-making powers by replacing strictly unconditional grants (special grants) by not-so-strictly unconditional grants (financial assistance grants) and conditional grants (specific purpose grants). This should be obvious from the recent growth of specific purpose grants, as will be shown below.

From the point of view of the Commonwealth Grants Commission, reduction in the number of claimant States would mean dwindling of the size of the Commission as well as its importance (as happened in the early 1970's), and the absence of any claimant State would have meant liquidation of the Commission under the 1933 Act. However, under the 1973 Act, even after the recent amendment in 1976, the Commission will continue to exist so long as the Local Governments require financial assistance, a long-lasting

10. For details see G. Thimmaiah, "Uniform Income Tax Arrangement in Australia", *Bulletin for International Fiscal Documentation*, April 1975, pp. 136-146.

reason for its continuance. But it will mean the dwindling of the size of the Commission from the presently-existing six members to only four members excluding the Chairman, if the present division of the Commission continues. This inevitable consequence must be kept in mind.

But a more significant policy implication of the gradual disappearance of the special grants will be the gradual dwindling of independent expert bodies from the deliberations of the Commonwealth-State fiscal relations. This is further evidenced by the Commonwealth Government's (Whitlam Government's) rejection of Commonwealth Bureau of Roads' *Report on Australian Roads 1973.* [11] If this trend continues, the Commonwealth Government will then be dealing with the States on a bilateral basis and may not hesitate to use its financial strings to impose its political will not only on the State Governments but also on the State politics. This will have its own political implications.

## III. THE INCREASE OF SPECIFIC PURPOSE GRANTS

The second important change which was injected by the Commonwealth Government into the Australian federal fiscal system was the steep increase of specific purpose grants particularly after 1970-71. For instance, in the decade between 1960-61 and 1970-71, the total amount of specific purpose grants increased by about three and half times from $A 169-72 million in 1960-61 to $A 584.40 million in 1970-71, whereas within a short period of three years between 1970-71 and 1973-74, the amount of these grants increased to $A 1,645.90 in 1973-74. [12] Further, it increased to $A 2,966 million in 1974-75, to $A 4,153 million in 1975-76 and to $A 4,193 million in 1976-77. [13] Even in relative terms, the proportion of specific purpose grants in the total federal fiscal transfers to the State Governments increased by 14.7 percent from 28.3 percent in 1970-71 to 47 percent in 1973-74 as compared to only a five percent increase from 23.3 percent in 1960-61 to 28.3 percent in 1970-71. Though this proportion declined slightly to 45.2 percent in 1974-75, it increased to 48.5 percent in 1975-76 and slumped again to only 45.1 percent in 1976-77. This phenomenal increase in specific purpose grants appears to be the result of a deliberate policy programme of the Commonwealth Government led by the Labour Party. This becomes evident from the statements of the former Prime Minister, Mr. Whitlam, who observed in the 1973 Conference of Commonwealth Government and State Government Ministers that "for this Government, however, the point of departure from the past practice is the degree of the national Government's involvement in the planning of the function for which it helps to provide finance. From now on we will expect to be involved in the planning of the function in which we are financially involved. We believe that it would be irresponsible for the national Government to content itself with simply providing funds without being involved in the process by which priorities are set and by which expenditures are planned and by which standards are met". [14]

What is more, he declared that "while we are prepared to see a substantial net increase in the funds flowing from the national Budget to the State and Local Government sector, it should not be assumed that this can be simply a process of increasing amounts being paid under existing arrangements or of introducing new supplementary arrangements. Where the national Government undertakes new or additional commitments which relieve the States or their authorities of the need to allocate funds for expenditure at present being carried by them, there should be adjustments in the financial arrangements between us to take account of the shift of new financial responsiblities. These adjustments will normally take the form of appropriate reductions in the general purpose funds allocated to the States". [15]

The Whitlam Government was fast in implementing this policy. For instance, it took over the entire financial responsibility of university and tertiary education from 1st January 1974 and correspondingly made downward adjustments in financial assistance grants. This implies that the State Governments have not benefited financially through this decision and that, on the contrary, they have lost *de facto* an important decision-making field to the Commonwealth Government. Education is an important field of public service which requires decentralised decision-making to cater to the various tastes and needs of the people of different localities. When decision-making power is indirectly centralized, the efficiency of decision-making and proper rendering of educational services is disturbed. This is a factor which must be recognised by the State Governments. However, the Commonwealth Government's policy decision may be defended on the ground of co-operative federalism. But whether it will promote such co-operative federalism or will only promote centralisation without substantially reducing federal fiscal imbalances and/or efficiency in essential public services in the Australian federation will have to be investigated after a period of time. Although the Liberal-

11. The Fraser Government has gone a step further at least in this field by abolishing Social Welfare Commission, Children's Commission and Commonwealth Bureau of Roads. It has no doubt created Bureau of Transport Economics to do the work of the earlier Bureau of Roads. It has also abolished (in January 1976) the earlier Universities Commission, the Commission on Advanced Education and the Technical and Further Education Commission, and has created one Commission, namely Post-Secondary Education Commission to do the work of the earlier three Commissions. See for details *1976 Report and Review of Fiscal Federalism in Australia*, Centre for Research on Federal Financial Relations, ANU, Canberra, April 1977, Ch. VI.
12. *Commonwealth Payments to or for the State*, Commonwealth of Australia, Canberra 1970, pp. 98-99, and P.B. Wade, "Recent Developments in Fiscal Federalism in Australia with special Reference to Revenue Sharing and Fiscal Equalisation", in R.L. Mathews (ed), *Fiscal Federalism: Retrospect and Prospect*, The Australian National University, Canberrra, 1974, pp. 48-50.
13. *1976 Report and Review of Fiscal Federalism in Australia*, p. 80.
14. *Proceedings of the Conference of Australian Government and State Government Ministers Held at Canberra*, 18-29, June 1973, Part I, p. 2.
15. Ibid.

Country Coalition Government Federalism Policy declared the reversal of specific purpose payments and the absorption of such payments into general revenue funds, this promise has not been borne out by the trends in the specific purpose grants for 1976-77 and 1977-78. Though in the earlier agreement, reached in April 1976 Premier Conference, it was thought that the reversal trend would not be commenced before 1977-78, in actual practice it started in 1976-77. The Commonwealth Government has abolished or reduced many specific programmes of grants without giving any offsetting increases in general purpose funds. Further, the Commonwealth Government has initiated many major revisions of specific purpose programmes during 1976, which revisions seem likely to result in the consolidation of many programmes into block grants. For instance, under the community health programme individual grants have already been replaced by block grants. Thus, the promises of the Fraser Government for reduction in the specific purpose grants programme and offsetting increases in the general purpose grants to give freedom to the State Governments to spend according to their own priorities and needs have not been kept. It remains to be seen whether the State Governments are prepared to forego additional financial assistance merely becuase it happens to be in the form of specific purpose grants.

## IV. THE REDUCTION OF THE POWER OF THE STATES IN THE LOAN COUNCIL

The third and unfortunate change which the Commonwealth Government led by the Labour Party attempted to make in the Australian federal fiscal system was its attempt to weaken the power of the States in the Loan Council. This intention becomes obvious from two epidodes created by the former Commonwealth Government. The first episode was created early in 1974 when the Commonwealth Government attempted to amend the Constitution, particularly the sections relating to the Loan Council, in order to obtain borrowing powers for Local Governments in Australia. This was a deliberate attempt to weaken the State's influence on the Local Governments. This episode ended in a fiasco when the Constitutional referendum for amending the Constituiton was rejected by the Australian people in May 1974. The second episode was created in December 1974 but only came to light in 1975. That is, the Commonwealth Government violated section 105-A of the Constitution by independently deciding to raise a foreign loan of $A 4,000 million in December 1974 without the concurrence of the Australian Loan Council. The Australian Loan Council is responsible for raising internal as well as external loans for both the Commonwealth and the States Governments. [16] Any Loan raising, except temporary loans and the Commonwealth Government's loan for war purpose, must be approved by the Loan Council. This was not done in the case of this loan which was proposed to be raised abroad (though it has not in fact been raised) for the alleged purpos of purchasing mineral rights of the foreign companies which are operating in Australia. [17] This proposal was in contravention to the Financial Agreement of 1927 which centralized all Government borrowings in the Loan Council. Under the Australian Constitution both the Commonwealth and the State Governments have concurrent powers of borrowing within Australia and abroad. This power encouraged the States to indulge in uncoordinated borrowing abroad, particularly in London in the 1920's, thereby endangering the credit of Australia. The Financial Agreement of 1927 put an end to it. But the then Commonwealth Government attempted to indulge in uncoordinated borrowing abroad, violating clauses 3.8, 4.1 and 4.4 of the Financial Agreement of 1927.

This will have its impact on the future of the Loan Council. The Loan Council is due to lose its powers by 1985 and now the Constitutional experts are already analysing whether section 105-A will be in operation after 1985. [18] The former Commonwealth Government's attempted violation of the Loan Council's jurisdiction has given an excuse for the State Governments to decide whether they should continue to submit their borrowing powers to the deliberations of the Loan Council after 1985. This is not a happy situation so far as the internal as well as the external credit of the Commonwealth Government is concerned. If the Loan Council becomes inoperative after 1985, the same old "orgy of public borrowing" within and outside the country may raise its ugly head with all its economic and political policy implications. Within the country the Commonwealth Government's economic stabilisation policy will be weakened, and outside the country it will have to face embarassing political situations.

A minor interesting trend which emerged in 1976 was the Commonwealth Government's budgetary deficit on the loan account. This deficit had to be financed by funds taken from the Loan Council's borrowings. In this context the States got an opportunity for the first time to comment on the Commonwealth Government's share of borrowings.

## V. THE REVISION OF THE UNIFORM INCOME TAX ARRANGEMENT

Finally, the Fraser Government has revised the uniform income tax arrangement to the advantage of the State Governments. [19] The uniform income tax arrangement

16. See for details G. Thimmaiah, "Allocation of Loan Funds by the Loan Council: A Suggested Approach", *Economic Activity*, October, 1972.

17. See for details "Parliamentary Reports: Australia", *The Parliamentarian: Journal of Parliaments of the Commonwealth*, Vol. LVI, No. 4, October 1975, pp. 243-246.

18. See for details R.S. Gilbert, *The Future of the Australian Loan Council, With an Annotation of the Financial Agreement 1927-66*. (Research Monograph No.6), Centre for Research on Federal Financial Relations, The Australian National University, Canberra, 1974.

19. The Uniform Income Tax Agreement came into operation during 1939-40, under which the state governments in Australia were persuaded to rent out their concurrent power to levy income tax to the Commonwealth Government in return for

was renewed for another 5 years up to 1980 in the June 1975 Premiers' Conference under the aegis of the Whitlam Government. On that occasion the State Governments recommended to the Commonwealth Government "…. that the base on which the formula grants in 1975-76 are calculated be increased by $A 350 million and that the present average wage element in the formula be replaced by a new progression factor equal to 1.5. times the increase in average wages each year". [20] But the Australian Government flatly rejected this proposal on the ground that it was based on the idea "…….. that the grants arrangements should be based, in effect, on reimbursement or compensation for income tax foregone. That concept has long been abandoned. Successive Australian Governments have taken the view that it is more logical and appropriate that the grants be based on the State's financial needs rather than on movements in one of the revenue sources from which the financial assistance grants are financed." [21] With a view to pacifying the State Governments, the former Commonwealth Government had increased the total amount of financial assistance grants by $A 200 million from 1975-76 and also had increased the betterment factor from 1.8 percent to a full 3 percent. Besides, the base grant for Western Australia was increased by $A 5 million from 1975-76.

These changes increased the total amount of financial grants by $A 2,200 million over a period of five years beginning from 1975-76. Since the State Governments were getting more in absolute terms, they were satisfied with this *ad hoc* arrangement. Perhaps they could do nothing in the context of a pro-Canberra Government and the public opinion which was strongly in favour of the then prevailing arrangement regarding uniform income tax in spite of its inconsistency with the principle of federal finance. The federal Opposition Parties proposed during the December 1975 federal elections to replace it with a tax-sharing plus equalisation system similar to that which operates in Canada. [22] Surprisingly, the State Governments won their case at least partially with the Commonwealth Government immediately after the 1975 federal elections. The Fraser Government conceded partial restoration of States' income tax powers. Under the revised scheme, which came into effect from 1976-77, the changes will be introduced in two stages. In the first stage, which started in 1976-77, the State Governments will receive 33.6% of the Commonwealth personal income tax collection in that year, including the collection in the Territories at least initially but excluding the effects of special surcharge or rebates applied in appropriate circumstances by the Commonwealth. The States entitlement in the first stage in any year will not be less in absolute terms than in the previous year, and in the four years from 1976-77 to 1979-80 it will not be less than the amount which would have been yielded by the financial assistance grants formula laid down in the State Grants Act of 1973-75. The total States entitlement will be divided among the States initially on the basis of the per capita relativity [23] in the financial assistance grants in 1975-76 and this relativity will be carried forward to future years subject to (a) the relationship between Queensland's special grants and the tax share arrangements to be considered by the Commonwealth and Queensland Governments as necessary, (b) the periodic review of relativities included by States on the basis of advice from an independent review body, the first review to be carried out before the end of 1980-81, and (c) any absorption of specific purpose payments.

In the second stage, which is likely to come into operation in 1977-78, each State may legislate to impose a percentage surcharge on personal income tax in the State in addition to the Commonwealth income tax, or to give at cost to the State a percentage rebate on Commonwealth income tax, and to authorise the Commonwealth Government to act as its agent in collecting the surcharge or granting the rebate.

The Commonwealth Government will continue to determine uniform assessment provisions and the basic income tax rate structure, and will remain the sole collecting and administrative agency with respect to income tax. Information on the disposition of Commonwealth tax to States and Local Governments will be provided separately but in conjunction with assessment notices, which will be changed only to record State surcharges or rebates. State surcharges or rebates will be determined by individual States, but in an appropriate framework in consultation with the Com-

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compensatory grants to begin with (known as tax-reimbursement grants), which later became equalisation grants (known as financial assistance grants). Though this agreement was supposed to cease immediately after the World War II, it has been extended on a quinquennial renewal basis. For details see G. Thimmaiah, "Uniform Income Tax Arrangement in Australia", *Bulletin for International Fiscal Documentation*, April 1975.

20. "Prime Minister's Statement to Premiers Conference", *Australian Government Weekly Digest*, 16-22 June 1975, p. 409.

21. Ibid.

22. In Canada, in addition to Equalisation of Provincial Revenues, which came into operation in 1967, Provincial Income Tax Revenue Guarantee Payments, and Revenue Stabilisation Payments schemes were introduced in 1972. Under the Equalisation of Provncial Revenues scheme, provinces with per capita revenue yields (from about 22 sources) below the national average receive equalisation payments from the Federal Government. From April 1, 1972, Provincial Income Tax Revenue Guarantee payments scheme was introduced to induce the Provinces to adopt income tax legislation conforming to the new Federal Income Tax Legislation, by guaranteeing to make good the loss of revenue if any to the Provinces under such new provincial income tax legislation covering both personal and corporate income tax. Furthur from 1972 the Federal Government has also guaranteed the Provinces under the Revenue Stabilisation Scheme against any loss of revenue in any year as compared to the previous year as a result of a downturn in economic activity. For details see *Federal — Provincial Fiscal Relations in Canada: An Overview*, Department of Finance, Ottawa, September 8, 1975.

23. This is a term used in the official documents relating to financial assistance grants in Australia to indicate the relative per capita grants for which each of the six states becomes entitled. Such per capita grants are determined on the basis of a formula called financial assistance grants formula, which is laid down in the *States Grants Act 1973-75*, after all the six states and the Commonwealth Government reaching an agreement on the factors which could be included in the formula. This formula includes the factors which indicate the relative financial needs of the six states.

monwealth and the other State Governments. Equalisation arrangements will apply to the surcharges. The amounts payable will be assessed by the Commonwealth Grants Commission but will be calculated for a less populous State by applying its rate of surcharge to the difference between its per capita revenue base and the average per capita base of New South Wales and Victoria. The Commonwealth Government has required the State Governments to cooperate with it in national economic policies. For the purpose of achieving such cooperation, it has created an *Advisory Council for Intergovernment Relations* consisting of 22 members, five of which will be from the Commonwealth Parliament, one from each of the six State Parliaments, six representing Local Governments, and five representing the private citizens; in addition, one Chairman is to be appointed by the Commonwealth Government. This council was created in March 1977 with only 21 members with its Secretariat in Hobart. [24]

From the foregoing analysis it becomes clear that the Commonwealth Government, by extending the scope of the Commonwealth Grants Commission to cover the financial needs of the Local Governments, has reduced their financial dependence on the States. On the other hand, by expanding the specific purpose grants to the States, it has tried to increase the financial dependence of the States on the Commonwealth Government and hence its control over the States' decision-making powers. However, the political teeth of these changes have been removed by the Fraser Government with a view to appeasing the State Governments.

Thus, the Australian federal fiscal system has changed substantially from the earlier predominance of unconditional grants to the current dominant position of conditional grants. The long-standing demand of the State Governments to restore their income tax powers has been partially conceded in principle by the Commonwealth Government. This should have obvious implications for a similar tax rental arrangement [25] operating in India. Finally, the role of the Commonwealth Grants Commission has been increased so as to cover the financial needs of the Local Governments. This part of the change in the federal fiscal system is a most appropriate and welcome change as ultimately it is the financial needs of the Local Governments which are basic in any democracy. This specific change is worthy of emulation in other federations, particularly in India.

24. See *1976 Report and Review of Fiscal Federalism in Australia*, p. 78.
25. See for details G. Thimmaiah, "Tax Rental Arrangement in India", *Bulletin for International Fiscal Documentation*, November 1975.

# Steuerliche Anreize für deutsche Investitionen in der Dritten Welt

von Rainer Offergeld, Bundesminister für wirtschaftliche Zusammenarbeit

Die Bundesrepublik Deutschland misst der weltweiten wirtschaftlichen Zusammenarbeit grosse Bedeutung bei. Der Wohlstand hängt von industriellen Investitionen ab, die nur durch eine weltweite Arbeitsteilung möglich sind. An dieser Arbeitsteilung ist die Bundesrepublik sehr interessiert. Wir setzen uns für einen weiteren Ausbau mit unseren Möglichkeiten ein. Wenn auch der grösste Teil des Güteraustausches und des gegenseitigen Kapitaltransfers innerhalb der Gruppe der Industrieländer stattfindet, so gewinnt doch die Einbeziehung der Entwicklungsländer in die weltweite Arbeitsteilung zunehmend an Bedeutung.

Der Notwendigkeit für die Entwicklungsländer, Kapital und technologisches Wissen von aussen zu erhalten, entspricht der Wunsch heimischer Unternehmen, durch Investitionen im Ausland Kostenvorteile für die Produktion zu nutzen, entfernte Märkte neu zu erschliessen, Zollbarrieren zu überwinden oder Rohstoffe zu sichern. Davon profitieren zunächst die am weitesten fortgeschrittenen Entwicklungsländer am meisten. Dies ist eine Konsequenz der Suche privaten Kapitals nach attraktiver Anlage. Diese Investitionen regen jedoch auch den Austausch zwischen den Entwicklungsländern an. Mexiko und Brasilien sowie einige Länder in Ostasien sind Beispiele für einen sich anbahnenden Handel mit industriellen Fertigprodukten unter Entwicklungsländern aufgrund ausländischer Investitionen. Die Investitionen deutscher Unternehmer in Entwicklungsländern sind in den letzten Jahren stark gestiegen. Sie hatten Ende 1976 einen Gesamtbestand von 14,2 Mrd DM erreicht.

Die Bedeutung des wirtschaftlichen Wachstums und der Arbeitsteilung in der Welt fordern von uns neue Anstrengungen. Der Weltwirtschaftsgipfel im Juli 1978 in Bonn beschloss dazu: „Wir unterstreichen unsere Bereitschaft zu einer engen Zusammenarbeit im Bereich der privaten Auslandsinvestitionen unter den Industrienationen sowie zwischen ihnen und den Entwicklungsländern."

Allerdings liegt ein Erfolg nicht nur in unserer Hand. Zu Recht fordert der Wirtschaftsgipfel deshalb die Entwicklungsländer auf: „Die Entwicklungsländer müssen an der Schaffung eines guten Investitionsklimas und eines ausreichenden Schutzes für ausländische Investitionen mitwirken, damit private Auslandsinvestitionen das Wirtschaftswachstum und verstärkten Technologietransfer wirksam fördern können."

Nicht nur der Mangel an Fachkräften, an Infrastruktur und Kaufkraft in den Entwicklungsländern wirken sich hemmend auf das Engagement ausländischer Unternehmer aus, auch rechtliche und politische Bedingungen behindern die Investitionen. Die Bundesregierung bemüht sich deshalb bilateral und auf internationalen Konferenzen, jenen Grundsätzen zu allgemeiner Anerkennung zu verhelfen, die Voraussetzung für ein günstiges Investitionsklima sind. Dazu gehören u.a.

RAINER OFFERGELD

*Rainer Offergeld was born in Genoa in 1937. He studied law and economics in Freiburg, Frankfurt, Zurich and Lyon.*

*After his assessor examination he worked as a notary and thereafter joined the tax administration. He also attended the Federal Academy of Finance (Bundesfinanzakademie).*

*In 1969, he was elected a member of the Federal Parliament (Bundestag).*

*In March 1972, Mr. Offergeld was asked to join the then combined Ministry of Finance and Economics as Parliamentary Secretary of State.*

*After the General Elections in 1972, he was appointed a member of the Board of his parliamentary group and at the same time acted as deputy chairman of the parliamentary Finance Committee.*

*In 1975, he was again brought in to the Ministry of Finance as a Parliamentary Secretary of State, where he was recognized as an expert in taxation.*

*In February 1978, Chancellor Helmut Schmidt appointed Mr. Offergeld Federal Minister of Economic Cooperation.*

— Gleichbehandlung in- und ausländischer Unternehmer,
— freier Gewinn- und Kapitaltransfer,
— unverzügliche und frei transferierbare Entschädigungen in angemessener Höhe im Enteignungsfall,
— unparteiische Gerichtsbarkeit.

Die Bundesregierung misst diesen Vorbedingungen entscheidende Bedeutung bei.

Die Bundesregierung hat ein Instrumentarium der Investitionsförderung geschaffen, um zusätzliche Anstösse zu geben. Sie fördert Investitionen in Entwicklungsländern besonders durch die Deutsche Gesellschaft für wirtschaftliche Zusammenarbeit (DEG) in Köln, besondere Kredite, Investitionsförderungsverträge, Doppelbesteuerungsabkommen und Ausfuhrbürgschaften.

Ein wichtiges zusätzliches Instrument der Förderung ist das Entwicklungsländer-Steuergesetz. Das bisherige Gesetz läuft Ende 1978 aus. In der von der Bundesregierung vorgeschlagenen und nun im Parlament zu beratenden Neufassung sind Massnahmen vorgesehen, die den steuerlichen Anreiz besonders für Investitionen in den am wenigsten entwickelten Ländern verstärken sollen. Die Bundesregierung möchte damit ihre möglichkeiten, die wirtschaftliche Entwicklung in der Welt zu fördern, von sich aus noch weiter ausschöpfen.

Das Entwicklungsländer-Steuergesetz fasst nach Meinung der Bundesregierung mehrere Zielsetzungen zusammen, nämlich Förderung privater Kapitalanlagen in Entwicklungsländer, Sicherung der Rohstoffversorgung der Bundesrepublik, generelle Förderung von Investitionen im Ausland. Eine scharfe Trennung von entwicklungspolitischen, aussenwirtschaftlichen und rohstoff- bzw. energiepolitischen Zielen ist kaum möglich. In der Regel kommen mehrere Aspekte gleichzeitig zur Geltung. Die vorgesehene Regelung innerhalb eines einheitlichen Gesetzes schliesst nich aus, dass einzelne Regelungen unterschiedlich stark von der einen oder anderen Zielsetzung geprägt sind. So ist die verstärkte Förderung von Kapitalanlagen in den am wenigsten entwickelten Ländern vor allem entwicklungspolitisch motiviert.

Die Bundesregierung schlägt im einzelnen folgende Verbesserungen des gegenwärtig geltigen Gesetzes vor:

1. Das neue Gesetz gilt zeitlich unbegrenzt. Die Erfahrungen mit privaten Kapitalanlagen in Entwicklungsländern zeigen, dass die Vielschichtigkeit der damit aufgeworfenen Probleme stets längere Zeit für die notwendigen Entscheidungen in Anspruch nimmt. Die Umwandlung des bisher als ein Zeitgesetz geltenden Entwicklungsländer-Steuergesetzes in ein unbefristetes Gesetz ermöglicht eine bessere Einbeziehung in die langfristige Planung der Unternehmen.

2. Die Auflösungsfrist für Rücklagen bei Investitionen in den Ländern der Gruppe 1 (dazu gehören die am wenigsten entwickelten Länder) wird verlängert. Neben den bekannten politischen Risiken sind private Kapitalanlagen in diesen Ländern gehemmt, weil die wirtschaftlichen Voraussetzungen für privatunternehmerische Engagements zum grossen Teil fehlen. Investitionen werden behindert durch die geringe Aufnahmefähigkeit lokaler Märkte, Standortnachteile, unzureichende Infrastruktur, geringen Ausbildungsstand der einheimischen Fachkräfte. Um die erwünschten Kapitalanlagen in diesen Ländern noch stärker als bisher zu fördern, wird die Auflösungsfrist für den erhöhten Rücklagensatz (100 Prozent) von 6 auf 12 Jahre verlängert. Das wirtschaftliche Risiko einer langen Anlaufzeit lässt sich damit mildern.

3. Für den Bereich der übrigen Entwicklungsländer (Gruppe 2) wurden für Kapitalanlagen im Rohstoff- oder Energiebereich die Rücklagen erhöht und die Auflösungsfrist verlängert. Die Bundesregierung geht davon aus, dass private Kapitalanlagen gerade im Rohstoff- oder Energiebereich stärker als andere Kapitalanlagen besondere Risiken mit sich bringen und besonders lange Anlaufzeiten benötigen. Dazu kommen kumulierte Risiken aus sehr hohen Investitionskosten einerseits und einer durch Ungewissheit über die zukünftige weltwirtschaftliche Entwicklung bedingten unsicheren Absatzmarktlage andererseits. Um einem Rückgang neuer Investitionen in Entwicklungsländern in diesem Sektor entgegenzuwirken, sollen die steuerlichen Fördermassnahmen durch die Erhöhung des Rücklagensatzes von 40 Prozent auf 60 Prozent und durch die Verlängerung des Auflösungszeitraumes für die Rücklage von 6 auf 12 Jahre verbessert werden. Die erste Massnahme soll vor allem eine verstärkte Hilfe bei der Aufbringung des erforderlichen Eigenkapitals bringen, während die zweite den langen Anlaufzeiten gerecht werden soll.

   Allerdings werden nur solche Kapitalanlagen gefördert, bei denen der Bundesminister für Wirtschaft im Einvernehmen mit dem Bundesminister für wirtschaftliche Zusammenarbeit die besondere Förderungswürdigkeit für die rohstoff- oder energiepolitische Zusammenarbeit bestätigt.

4. Deutsche Unternehmen erhalten bei Investitionsvorhaben im Bereich der Gewinnung von Bodenschätzen, die durch internationale Konsortien durchgeführt werden, oft weniger als 15 Prozent der Anteile. In diesen Fällen konnten daher beteiligungsähnliche Darlehen, die die deutschen Unternehmen den Anlageunternehmen gewähren, steuerlich nicht berücksichtigt werden. In der Neufassung des Gesetzes soll die Mindestbeteiligung für die Begünstigung derartiger Darlehen auf 5 Prozent herabgesetzt werden.

5. In der Neuregelung wird ebenfalls sichergestellt, dass aus der Zwischenschaltung einer Holdinggesellschaft mit Sitz in einem Entwicklungsland keine schädlichen Folgerungen gezogen werden. Es hat sich gezeigt, dass es aus organisatorischen Gründen zweckmässig ist, vielfache Beteiligungen an Kapitalgesellschaften in einem oder mehreren Entwicklungsländern regional zusammenzufassen.

Daraus ergeben sich folgende Hauptelemente der Neuregelung:

— das Entwicklungsländer-Steuergesetz wird es wie bisher den privaten Investoren ermöglichen, zu Lasten des Gewinns des inländischen Betriebs eine zeitlich befristete Rücklage zu bilden. Der Effekt der daraus entstehenden Liquiditätshilfe für das Unternehmen wird in Zukunft teilweise erhöht.

- die von der Bundesregierung vorgelegte Novelle trägt dem besonderen Interesse der Bundesregierung an der Zusammenarbeit mit Entwicklungsländern auf dem Gebiet der Rohstoff- und Energieversorgung Rechnung und fördert Investitionen in diesem Bereich in Entwicklungsländern verstärkt.
- die steuerliche Förderung wird noch stärker auf Investitionen in den am wenigsten entwickelten Ländern konzentriert.
- dieses Gesetz ist lediglich *ein* Element innerhalb des Gesamtinstrumentariums zur Förderung deutscher Investitionen in Entwicklungsländern.

Es muss betont werden, dass es sich bisher noch um Vorschläge der Bundesregierung handelt. Im Verlaufe der parlamentarischen Behandlung des Gesetzes sind Änderungen möglich.

Die Diskussion um Auslandsinvestitionen sowohl in anderen Industrieländern wie in Entwicklungsländern geht in unserem Land in zwei Richtungen. Manche befürchten durch private Auslandsinvestitionen eine Verringerung der Inlandsinvestitionen, den Verlust von Arbeitsplätzen und verstärkte Konkurrenz durch Fertigwaren von aussen. Anderen geht die besondere Förderung von privaten Investitionen für die ärmsten Entwicklungsländer nicht weit genug. Für die Bundesregierung ist es ausserordentlich wichtig klarzumachen, dass Auslandsinvestitionen langfristig auch für die inländische Produktion wichtig sind. Die Gefahren, die Auslandsinvestitionen zugeschrieben werden, bestehen zum Teil nicht, zum Teil werden sie durch ihren Nutzen bei weitem aufgewogen. Insgesamt gehen nur zwei bis drei Prozent der westdeutschen Wirtschaftsinvestitionen ins Ausland, davon rund 30 Prozent in die Rohstoffgewinnung und etwa 27 Prozent in Dienstleistungen, die u.a. zur Sicherung des Handels dienen (Kreditwesen, Versicherungen). Die Bundesrepublik hat als Auslandsinvestor noch einen Nachholbedarf. Obwohl sie als Welthandelspartner an zweiter Stelle steht, ist sie nur der viertgrösste Auslandsinvestor.

Manche Entwicklungsländer können ihre Anstrengungen verstärken, die Bedingungen für private Investitionen in ihren Ländern verbessern. Immerhin handelt es sich bei dem dadurch möglichen Zufluss an Kapital und technischem Wissen schon gegenwärtig um ein Mehrfaches der öffentlichen Entwicklungshilfe. Langfristig spricht viel für die These, dass der Spielraum für einen möglichen verstärkten privaten Kapitalzufluss zumindest ebenso gross ist wie der Spielraum einer erweiterten öffentlichen Hilfe. Diese Chance sollten die Entwicklungsländer nutzen.

Eine wesentliche Steigerung des Wohlstands der armen Länder wird nicht allein durch Opfer der Industrieländer möglich sein. Nur ein gemeinsam organisiertes Wachstum der arbeitsteiligen Weltwirtschaft kann die Entwicklung aller Länder voranbringen.

**SUMMARY** — Tax incentives for German investments in the Third World

*Since we received Mr. Offergeld's article immediately before going to press we were, unfortunately, unable to provide an English translation. However, in view of the importance of Mr. Offergeld's statements, we have attempted in the following summary to give the essentials of the German tax measures which are contemplated in order to expand German investment in developing countries.*

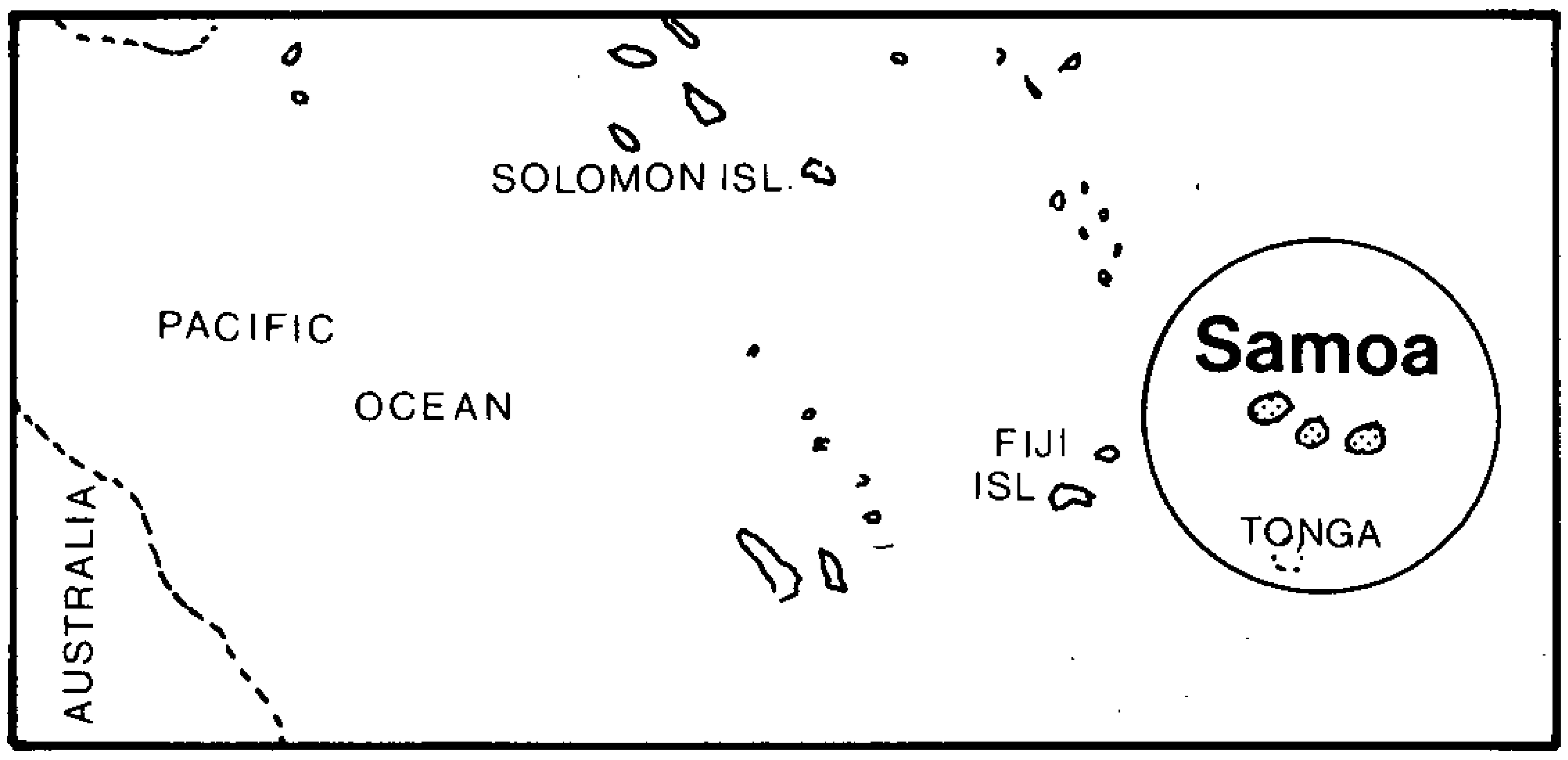
*Because the German Government sets a high value on providing aid to developing countries, it intends to continue and to extend the existing tax incentives which would otherwise expire at the end of 1978. The new provisions will be adopted for an unlimited period of time in order to allow better long range planning for German enterprises. As in the current legislation, developing countries will be divided in two groups, Group I comprising the least developed countries and Group II those countries which have a higher degree of development. The taxpayer may create for certain investments in developing countries a tax deductible reserve which must gradually be added back to taxable income after a certain number of years. With respect to Group I, the investment reserve may amount to 100 percent of the value of the investment and the period of time after which the reserve must begin to be restored to taxable income will be increased from 6 to 12 years. Investment in developing countries of Group II normally entitles the German enterprise to a tax deductible investment reserve of 40 percent of the value of the investment and its dissolution must start after 6 years. However, it is now proposed that where the German enterprise invests in the production of raw materials or of energy the investment reserve may amount to 60 percent of the value invested. In addition, the period of dissolution of the reserve will be increased by an additional 6 years to 12 years.*

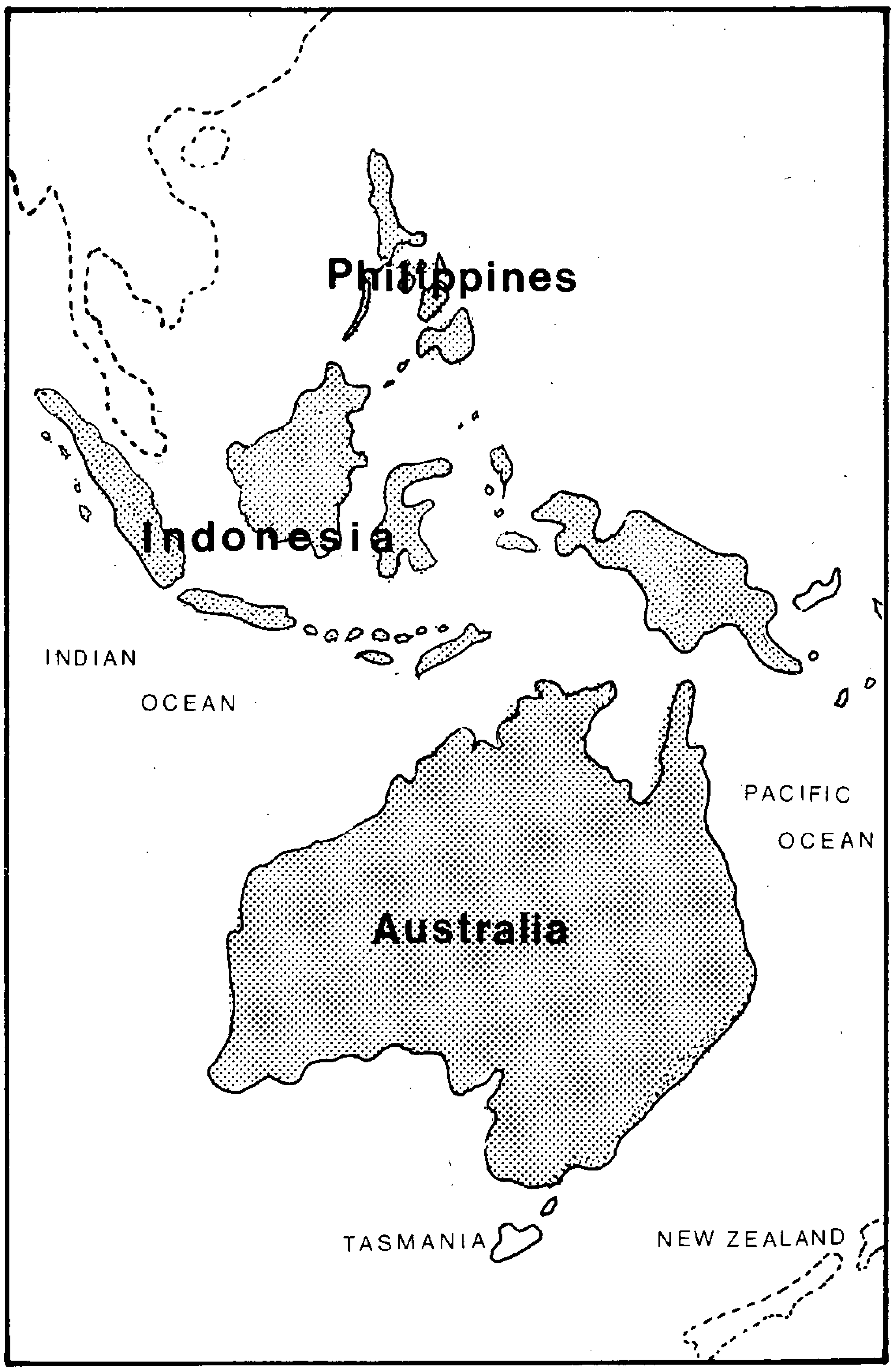
*The term "investment" includes — apart from investment in equity capital — certain loans made to companies in a developing country, provided that, inter alia, the lender owns directly or indirectly at least 15 percent of the equity capital of the borrowing company. It is now proposed that this be reduced to 5 percent of the equity capital in case of investment in the extraction of natural resources.*

*Finally, the new tax measures propose the introduction of a provision which will make it clear that the investment relief will not be lost if the German enterprise creates a holding company as an intermediary in a developing country.*

## 32nd International Congress of IFA (Sydney)

# FISCAL POLICY AND TAX STRUCTURES IN THE PACIFIC AND INDIAN REGIONS




On September 20, 1978 during the IFA Congress to be held in Sydney a special seminar will be devoted to the tax structures of countries in the Pacific Region and neighbouring areas and the fiscal policy followed by their Governments. This Seminar which will be chaired by Mr. S. Ambalavaner from Sri Lanka (Ceylon) has been largely coordinated by himself and Professor J. van Hoorn Jr., Managing Director of the International Bureau of Fiscal Documentation.

The Editors of the *Bulletin* are proud to be able to publish papers dealing with the subject of fiscal policy in 12 countries situated in the Pacific and Indian regions.

The first group of papers appeared in the June issue and comprised a number of Asian countries which are either highly developed, such as Hong Kong, Japan and Singapore, or which have reached a certain degree of development, such as South Korea.

The second group of papers, published in the July issue of the *Bulletin*, focussed on developing countries in the Indian region and discussed Bangladesh, India, Pakistan and Sri Lanka.

The third group of papers is to be found in this issue and deals — in honour of the 32nd Congress of IFA in Sydney — with Australia and countries in the neighbourhood of Australia, i.e. Indonesia, Philippines and Western Samoa.

A sufficient number of reprints of these papers will be available at the Sydney Congress for free distribution to the participants.

# AUSTRALIA: Tax Structure and Fiscal Policy

by Wesley G. Cook*

## CATALOGUE OF TAXES IMPOSED AT THE NATIONAL LEVEL

Various forms of taxation are imposed by Federal, State and Local Governments and it is essential, for a reasonable understanding of the Australian taxation system and the burden of taxation it creates, to briefly review the nature and scope of all taxes. Recent and proposed changes in taxation at various levels of Government will have a considerable bearing upon direct taxation in this country.

State Governments, which are traditionally responsible, inter alia, for administering health, education and housing programmes have found difficulty in financing escalating costs and have consistently sought the right to impose a growth tax of their own. In 1971 the right to levy payroll tax was transferred to the States and the revenue raised by this tax has more than doubled since that date. Notwithstanding the transfer of this growth tax, State finances are still heavily dependent upon Federal Government grants from company and income tax revenue.

To enable the States to finance their own budget expenditure without continuing to rely to such an extent upon Federal grants, to give taxpayers generally a better appreciation of the amount necessary to finance State expenditures and to ensure that States exercise budgetary restraint when fiscal policy policy of the Federal Government requires it, the Australian Government has announced that enabling legislation will shortly be introduced to empower the States to raise income tax. Some States have voiced their opposition to such legislation and have indicated that they will delay the introduction of necessary and complementary legislation. It is envisaged that this right to raise income tax at State level will eventuate and that State tax will be additional to the Federal income tax. A number of technical and administrative aspects have yet to be considered and it seems that immediate utilization of the power is unlikely. However in due course the tax should reduce the States' grants claims and some reduction in the level of Federal income tax can be anticipated in the longer term.

It will be readily understood that international comparisons are extremely difficult and liable to be misleading. However Australia has been a member of the Organisation for Economic Co-operation and Development (O.E.C.D.) since 1971 and that organisation has considerable expertise in adjusting and recasting statistics provided by member countries for purposes of comparison. Table A presents information extracted from the latest document available, Revenue Statistics of O.E.C.D. Member Countries 1965-1975 (OECD, Paris 1977).

* Partner of Peat, Marwick, Mitchell & Co., Sydney.

**TABLE A**

**INTERNATIONAL TAX COMPARISONS: OECD COUNTRIES, 1975**

| Selected OECD countries | Percentage of total taxes: Taxes on goods and services | Income tax: property | Income tax: profits | Social Security contributions | Other taxes* | Total taxes as percentage of Gross National Product |
|---|---|---|---|---|---|---|
| Australia | 8.76 | 2.80 | 16.82 | | 1.74 | 30.11 |
| Canada | 10.94 | 3.13 | 11.32 | 3.22 | .41 | 33.98 |
| France | 12.44 | 1.46 | 6.58 | 14.72 | 1.70 | 36.90 |
| Germany | 9.37 | 1.09 | 12.16 | 12.03 | .56 | 35.22 |
| Italy | 9.34 | 1.17 | 11.00 | 14.83 | – | 32.34 |
| Japan | 3.67 | 1.94 | 8.50 | 5.09 | 1.04 | 20.23 |
| Netherlands | 10.91 | 1.48 | 16.26 | 17.99 | .25 | 46.90 |
| Sweden | 11.48 | .51 | 23.16 | 8.89 | 1.93 | 45.96 |
| United Kingdom | 9.24 | 4.54 | 16.21 | 6.71 | .07 | 36.77 |
| United States | 5.49 | 4.13 | 13.28 | 7.42 | – | 30.31 |

* "Other taxes" include stamp duties, wealth tax, death and gift duties and payroll tax which are not earmarked as social security contribution.

*Source:* Revenue Statistics of OECD Member Countries 1965-1975 (OECD, Paris, 1977).

It seems that Australia is lightly taxed by international standards, 26.6 percent of gross national product being taken in tax in 1971 compared with the O.E.C.D. average of 31.8 percent. Table A suggests that this percentage has increased in most countries during the past four years and the relevant percentage in Australia in 1975 was 30.11 percent. However significant changes in the financing of social security benefits have not yet been reflected in available statistics and this reduces the value of the statistics provided.

It is particularly noticeable that Australian income tax (especially on companies) is a relatively heavy impost. So too are the miscellaneous levies grouped under "other taxes", a fact to be explained not by any peculiarity of taxation imposed at the national level, but by the very large measure of reliance by State and Local Governments on stamp duties, property taxes and payroll tax. By contrast, taxes on goods and services feature less prominently than they do in many countries.

Even these very summary figures show the Australian taxation system to be somewhat unusual. It is revealed as still more so when one looks behind these broad categories to the exact kind of taxes they contain. Table A does not reveal, for example, that in many countries a broad value added tax is the major domestic levy on goods and services, whereas Australia mainly relies on excise duties and wholesale sales tax which weigh heavily upon only a restricted range of goods and services. Also Australia is somewhat unusual in employing the "separate" or "classical" system of taxing companies and, until now, in not imposing capital gains tax. Australia does not impose any form of annual wealth tax and moves for the abolition of death and estate duties of all kinds have gained considerable momentum in recent times. Assurances have been given that the estates of persons who die domiciled in some States after July, 1979 shall not suffer estate or death duties. It is probable that the States still levying death duty will follow suit in due course.

Having mentioned the significance of revenues raised by State and Local Governments we shall now concentrate upon taxes imposed at national level.

**TABLE B**

**AUSTRALIAN GOVERNMENT TAXES: SELECTED YEARS SINCE 1949-50**

| | 1949-50 | 1959-60 | 1969-70 | 1974-75 | 1976-77 |
|---|---|---|---|---|---|
| Income tax — Persons | 392 | 884 | 2,855 | 7,966 | 11,054 |
| Companies | 167 | 455 | 1,187 | 2,566 | 2,824 |
| | 559 | 1,339 | 4,042 | 10,532 | 13,878 |
| Estate and gift duty | 14 | 32 | 80 | 77 | 97 |
| Customs duties | 155 | 168 | 414 | 770 | 1,273 |
| Excise duties | 132 | 504 | 939 | 1,765 | 2,486 |
| Sales tax | 85 | 328 | 569 | 1,105 | 1,650 |
| Payroll tax * | 45 | 110 | 230 | 12 | 21 |
| Other ** | 24 | 37 | 106 | 258 | 237 |
| Total | 1,014 | 2,518 | 6,380 | 14,519 | 19,642 |
| | Percentage of total taxes | | | | |
| Income tax — Persons | 38.7 | 35.1 | 44.7 | 54.9 | 56.3 |
| Companies | 16.5 | 18.1 | 18.6 | 17.7 | 14.4 |
| | 55.1 | 53.2 | 63.4 | 72.5 | 70.7 |
| Estate and gift duty | 1.4 | 1.3 | 1.3 | 0.5 | 0.5 |
| Customs duties | 15.3 | 6.7 | 6.5 | 5.3 | 6.4 |
| Excise duties | 13.0 | 20.0 | 14.7 | 12.2 | 12.7 |
| Sales tax | 8.4 | 13.0 | 8.9 | 7.6 | 8.4 |
| Payroll tax * | 4.4 | 4.4 | 3.6 | 0.1 | 0.1 |
| Other ** | 2.4 | 1.5 | 1.7 | 1.8 | 1.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

* Payroll tax was transferred to the States in 1971. The Australian Government now collects payroll tax only in its own territories.

** Including stamp duty (Australian Capital Territory and Northern Territory); wool contributory charge and tax; wheat export and tax; stevedoring charge; radio and television (now abandoned); fees, fines, etc.

*Source:* Australian Bureau of Statistics publications; 1974-75 and 1977-78 Budget papers.

The essential aspects of national taxes are:

## A. PERSONAL INCOME TAX

The Government is in the process of introducing important changes which will significantly alter the way in which Australian companies and individuals are taxed. The most far reaching of the reforms being introduced will affect the taxation of foreign source income.

Subject to a number of exceptions, the most important of which are mentioned below, tax is imposed upon the worldwide income of Australian residents and Australian sourced income of non-residents.

Significant exceptions are:

— dividends derived by non-residents which do not carry on business in Australia at or through a permanent establishment of the non-resident from Australian resident companies are subject to a final 30 percent withholding tax (tax treaties normally stipulate that the maximum rate of withholding tax on dividends paid to non-residents of Australia which are residents of other treaty countries is 15 percent).

— Australian residents are presently exempt from Australian tax on income (other than dividends) derived from sources outside Australia provided such income is assessable to tax in the country of its source. However as from July 1, 1978 such income will be fully taxable in Australia and subject to a credit equal to the Australian tax or the foreign tax whichever is less. For administrative convenience it has been decided that the first $10,000 of salaries and wages having a foreign source, shall continue to be exempt provided income tax was payable in the country of source. This exempted amount will, however, be taken into account for the purpose of determining the rate of tax applicable to the taxpayer's assessable income.

The Treasurer has stated that a credit will be allowed for a tax imposed at one or another Government level in the country in which the income is derived if the tax is one comparable with the Australian income tax. The foreign tax must have been paid and must, ordinarily, be a tax for which the taxpayer was personally liable. Credit will, however, be allowed for tax paid on a person's income by another person, such as an agent or trustee.

As is the case under credit systems generally, the credit for foreign tax paid in respect of a year will be limited to the Australian tax on the foreign source income of the year, and for this purpose the Government proposes to adopt the most generous of available methods by calculating the limitation on the basis of the aggregate foreign source income of the taxpayer.

— The Australian legislation contains criteria for deeming an Australian source to certain royalty and interest payments made to non-residents.

— A credit, not exceeding the applicable Australian tax, is available in respect of foreign taxes imposed upon dividends received by Australian residents and upon royalties and interest received from countries with which Australia has concluded comprehensive Double Tax Treaties.

Progressive rates of tax to be imposed on personal incomes during the 1978-79 fiscal year are:

| $ | % |
|---|---|
| 0 – 3,893 | Nil |
| 3,893 – 16,608 | 32 |
| 16,608 – 33,216 | 46 |
| 33,216 + | 60 |

## B. COMPANY TAX

The "separate" or "classical" system of taxation applies in Australia and all companies, both resident and non-resident, public and private are subject to tax equal to 46 percent of their taxable income. The rules for determining the taxable income of companies are similar to those which apply to individuals and it remains necessary to consider the source of income and the residence of the particular company.

A "resident" company is defined in the Income Tax Assessment Act and the following companies are residents for purposes of determining the application of that Act:

— All companies incorporated in Australia.
— All foreign incorporated companies having central management and control in Australia.
— All foreign companies which carry on business in Australia and have their voting power controlled by shareholders who are residents of Australia.

### (i) Dividend income

*Resident companies*

Subject to measures to prevent avoidance, resident companies have, in the past, been entitled to a rebate of Australian tax on all dividend income regardless of its source. The rebate has been generally equated to the Australian tax payable in respect of that dividend and effectively exempted dividends from further taxation as they pass from one company to another. These rules will continue to apply to dividends received by one Australian company from another but new rules will apply to dividends from outside Australia.

While full details are not yet available we understand that, with effect from the beginning of years of income or substituted accounting periods commencing on or after July 1, 1978, the basic rule will be that all foreign source income of Australian resident companies will be taxable in Australia. However, the Australian tax on that income will be reduced by credit for foreign tax.

Whereas the general rules applicable to personal income and referred to above are expected to apply, the basic rule will be that once such dividends are made effectively taxable by withdrawal from them of the rebate on inter-corporate dividends, a credit will be allowed for any foreign dividend withholding or other tax paid on them.

In addition, a credit for the "underlying" company tax on the profits out of which the dividends are paid will, on what is known as a "gross-up" basis, be allowed to Australian companies that have a more than portfolio investment in a foreign company. This credit will provide a direct recognition of the payment of any foreign company tax on those profits and will, at base, be allowed where the Australian company has a direct 10 percent or greater shareholding in the foreign company.

The credit for "underlying" tax will be extended beyond the underlying tax paid by the foreign company in which the Australian company has a direct 10 percent or greater interest to include such tax paid by a foreign company one further stage removed, if the Australian company has, through the first tier company, at least a 10 percent shareholding interest in the further company. To guard against avoidance, the relevant 10 percent or greater shareholding must have been held for at least twelve months prior to the date of declaration of the dividend for a credit for underlying tax in respect of that dividend to be allowed.

It is anticipated that detailed legislation to incorporate the above changes will be introduced around September, 1978.

*Non-resident companies*

Non-resident companies are not entitled to any rebate or credit and are taxable upon dividends received from resident or non-resident companies to the extent that such dividends are paid out of profits having their source (see below) in Australia. Subject to special withholding tax rules the normal rate of company tax for both resident and non-resident companies has been 46 percent and the introduction of a branch profits tax has not altered this position in so far as dividends are concerned.

**(ii) Non-dividend income**

*Resident companies*

Worldwide non-dividend income shall in future be taxable at the 46 percent rate and subject to credit as above.

*Non-resident companies*

Unless withholding or special treaty provisions apply, such companies are subject to Australian tax at the 46 percent rate on income having an Australian source.

The Government has recently clarified earlier statements concerning its intention to introduce a branch profits tax to negate the advantage that previously flowed to non-resident companies which chose to operate in Australia per media of a branch rather than a subsidiary, thus avoiding any withholding tax on profit remittances. Remittances of profit by Australian branches of overseas companies are still not subject to any form of withholding tax and the new branch profits tax is an attempt to restore the balance between resident/non-resident companies.

The additional tax to be levied on taxable income of non-resident companies will be at the rate of 5 percent of the taxable income of the branch. The tax is being levied in this form because it is considered to be impracticable to impose a tax on "remittances" of branch profits.

In striking a branch profits tax rate of 5 percent of taxable income, the Government has aimed to achieve, as closely as is practicable, a reasonable balance between the Australian tax liabilities attaching to profits of foreign-owned subsidiaries and branches, bearing in mind that, in both cases, the companies are likely to plough back some of their profits into further developments in Australia.

The branch profits tax does not fall on dividend income of branches, nor does it apply to film royalties, shipping profits or insurance premiums taxed under special provisions. It has also been decided to exclude from this tax the profits of non-resident life assurance companies that are allocated towards bonuses and other payments due to Australian policy holders. The Government has accepted the point that, if the tax were placed on these profits, it would effectively be borne by Australian policy holders and not, as intended, by the company or its overseas shareholders, if any.

The Government has decided that the tax will apply to that part of the 1977-78 tax year falling after November 4, 1977, and to subsequent years.

## C. WITHHOLDING TAX

Non-residents who do not carry on business in Australia at or through a permanent establishment are generally subject to 30 percent withholding tax on dividends (15 percent to treaty countries) and 10 percent withholding tax on interest. In addition, interest paid by a non-resident to another non-resident may be subject to Australian withholding tax if the interest expense is an outgoing incurred by the first-mentioned non-resident in carrying on business in Australia at or through a permanent establishment of that person in Australia. It is significant to note that the term "permanent establishment" is defined even more widely than in international tax agreements based upon the model provided by the Organisation for Economic Cooperation and Development. Withholding tax on interest and dividends is a final tax and companies may be denied tax deductibility for interest payments if they fail to deduct the required amount of withholding tax. Special approval for the exemption of interest withholding tax on interest payable by "Australian entities" to non-residents is possible and, where, the non-resident recipient is effectively free of any Australian tax on that interest.

Every person who is liable to pay money as or by way of royalty to a non-resident is obliged to first ascertain the amount, if any, to be retained in respect of tax due, or which may become due by the non-resident. Royalty has been defined widely and might include management fees, rental and lease payments in addition to payments ordinarily within the meaning of that term. However all payments must be considered separately as it is generally agreed that amounts paid for services provided, as distinct from payments for the use of assets, technology or know-how already in existence, are not to be regarded as royalty.

Royalty tax withheld and remitted to the Commissioner of Taxation is not a final tax and the recipient may elect to lodge an Australian tax return and, if the amount withheld is found to be excessive, a refund will be made. Whereas additional tax could become payable if a separate return is lodged the non-resident will not be obliged to lodge a separate return unless it derives other income assessable to Australian tax.

## D. ESTATE AND GIFT DUTY

Federal estate duty, at a maximum rate of 27.9 percent, has for many years been charged upon dutiable estates having a value in excess of $1 million. Lower valued estates attract lower rates of duty and no duty is payable on estates which have a value of less than $20,000. However the dutiable estate may include property not owned by the deceased such as gifts made within three years of death, gifts where the disponor retained rights to enjoyment or property at the disposal of the deceased immediately prior to his death. The criteria for determining dutiable estate are complex and, apart from mentioning the fact that domiciliaries are generally required to include real estate located within the jurisdiction and personal property wherever it is located, they will not be further considered. Treaties and provisions which may grant relief from double duty are of extremely limited assistance.

## E. TAXES ON COMMODITIES (CUSTOMS, EXCISE AND SALES TAX)

There are at present effectively two Federal taxes on commodities imposed primarily to raise revenue. These are the wholesale tax and excise duty — in which should be included the "excise component" of customs duty. Where a good is subject to excise duty when manufactured in Australia, it is more or less automatically subject to a similar customs duty when imported. This "excise component" is in no way related to the "protective" element of customs duty imposed to provide assistance to Australian industry. In 1971/72 the "protective" element of customs duty yielded about $419 million and the revenue element about $49 million.

Excise is levied at a specific rate per unit of quantity so that the yield increases only with increases in consumption of the items concerned or with increases in the applicable rates. Price changes do not affect collections. Thus although quite substantial increases in the rates of excise have occurred over the years and especially since 1967-1968 collections have increased at a slower rate than taxation collections generally. Perhaps the main feature of Australian revenue taxes on commodities is the extent to which they fall heavily on a comparatively small number of commodities. In 1971 to 1972 78 percent of the total amount collected was obtained from the taxes on alcoholic beverages, tobacco products, petroleum products, motor vehicles and spare parts. The concentration of our indirect taxation system on a small number of goods is further illustrated by the comparative levels of taxation on these commodities. Table C purports to show the extent to which taxes contributed to the final retail prices of various goods and Table D shows the extent to which these taxes fall on a small number of commodities.

**TABLE C**

**APPROXIMATE WEIGHT OF TAX, INCLUDING "MARK-UP" ON TAX, AS PERCENTAGE OF RETAIL PRICE**

| Product | Proportion of Final Retail Price represented by Tax plus "Mark-Up" on Tax |
|---|---|
| | % |
| Beer (Sydney) a) | 77 |
| Cigarettes (average of four major brands) a) | 59 |
| Potable spirits (various) b) | 45 to 60 |
| Petrol (super grade, Sydney) a) | 40 |
| Motor vehicles | |
| Private c) | 16 |
| Commercial c) | 10 |
| Spare parts and accessories b) | 13 |
| Other goods subject to general rate of sales tax c) | 13 |
| Household goods c) | 2 |

a) Excise and excise component of customs duty.
b) Sales tax, excise duty and excise component of customs duty.
c) Sales tax.

*Source:* Treasury Taxation Paper No. 5, October, 1974.

**TABLE D**

| Product | Collections 1971-1972 | 1976-1977 * |
|---|---|---|
| | $m | |
| Tobacco products | 321 | 55 |
| Beer | 399 | 740 |
| Potable spirits | 56 | 71 |
| Gasoline | 409 | 772 |
| Other petroleum products | 55 | 340 |
| Motor vehicles and spare parts | 277 | 760 |
| | 1,517 | 3,238 |
| All other | 427 | 2,171 |
| Total | 1,944 | 5,409 |

* These figures are estimates only, based on information contained in the 1977/78 Budget Speech of the Treasurer of Australia.

## F. PAYROLL TAX

This tax is imposed upon employers and calculated by reference to the level of wages and salaries they pay to employees. Employers which pay less than $100,000 Australian per annum are generally exempt from this form of taxation but all other employers are taxed at a common rate. The right to impose this tax upon employers was handed over by the Commonwealth Government to the States in 1971 and since that time the amount of tax raised in this way has increased considerably. Most States now impose payroll tax at a rate of 5 percent on wages and salaries.

## G. LOCALISED TAXATION

State and/or Local Government taxes are imposed upon persons residing, owning property, or transacting business within specified boundaries. The Federal taxes referred to above raise approximately 80 percent of all taxation levied in this country and the remaining 20 percent is made up of a variety of State and Local Government taxes.

The chief forms of such taxation are:

*Gift duties* — only some States impose gift duty as such. However all States impose stamp duty on the rate of stamp duty payable on transactions or documents which transfer valuable property without adequate consideration are higher than normal.

*Death duties* — most States still impose some form of duty based upon the value of the estates of deceased persons who are domiciled at the date of death or who owned property within the State at the date of death. The rates of tax are progressive and on estates in excess of $1 million amount to approximately 32 percent. Most States within Australia have recently introduced legislation, or announced an intention to do so, the effect of which will be to exempt from death duties the value of estates passing between surviving spouses and in some cases to surviving children. It is generally considered that within a short period all such duty will have been abolished.

*Land tax*
This State tax is based upon an assessed annual value of real estate located within the jurisdiction. Special rules apply to rural land and principal plans of residence.

*Stamp duties*
This is a complicated form of taxation with considerable differences existing in various States. The duty, at varying rates, is charged upon most documents, transactions and loan securities with which the State can establish an adequate territorial nexus.

*Registration fees*
Annual fees are paid by companies and others for licences to carry on business in each of the Australian States.

*Municipal rates*
This tax, which is based upon the value of land owned in the particular municipality, is intended to provide finance for adequately servicing the sewage, waste collection, cultural and recreational requirements of localised areas.

## ORIENTATION OF FISCAL POLICY

Australia has adopted a variety of techniques to ensure that industrial and commercial development occurs in an orderly manner and in accordance with overall policy objectives. Some of the review and control techniques used in recent times are:

- Careful control of the rate of growth of the money supply. This is achieved by closely regulating the liquidity levels of trading banks operating in Australia and it has been necessary to pay considerable attention to international exchange rates and the inflow of private capital. During recent years when it has been felt the high levels of capital inflow would produce an excessive growth in the monetary supply, a variable deposit requirements has applied. In this way the Australian borrower has been obliged to deposit, free of interest, a portion of the monies borrowed from abroad with the Australian Reserve Bank and, as a consequence, the overall cost of borrowing has been increased. At times the variable deposit requirement has been as high as 33 1/3 percent of overseas borrowings but it is not in operation at the present time.
- Foreign investment is closely monitored by the Foreign Investment Review Board. It is the policy of the Australian Government to encourage foreign investment in Australia and to offer fair treatment under clear guidelines which include restrictions on the introduction of foreign capital into banking, radio, television and certain aspects of the civil aviation industry.

  It is necessary to obtain Foreign Investment Review Board approval before:
  — Acquiring more than 15 percent of the shares or assets of an Australian owned company or where, as a result of a particular transaction, the voting power held by overseas interest in an Australian company is 40 percent or more. The Government has announced that it will not normally seek to intervene if the assets of the company being taken over are less than $2 million, unless there are special circumstances or the business is in the financial sector or some other area where special considerations apply.
  — Real estate acquisitions of a value greater than $250,000.
  — Implementing proposals involving financial institutions or insurance companies.
  — Implementing proposals (in excess of $5 million) for establishing new business or undertaking new mining or natural resource projects.

- Direct subsidies or grants are available to encourage export market development and industrial research. Generally speaking such grants are taxable as ordinary income from business activities.
- The Export Finance and Insurance Corporation has been established to ensure that exporters from Australia have access to export credit insurance and guarantees on loan facilities.
- Price increases are kept under surveillance by the Prices Justification Tribunal.
- The regulation, and in some cases prohibition, of certain forms of business activities are controlled pursuant to the Restrictive Trade Practices Act.
- The Australian and several State Governments have indicated their commitment to the concept of industrial growth centres outside the major capital cities. A variety of concessions, subsidies and assistance is offered to attract industry to these growth areas and it is hoped that this policy will divert increases in population away from the heavily populated seaboard cities.

## TAX INCENTIVES TO INDUSTRY

A. **Enterprises engaged in certain industries** are subject to special tax concessions. For example:

*Farming, grazing, etc.*
Certain categories of "capital" expenditure incurred by primary producers are allowed as a deduction spread over a period of ten years. Depreciation allowances (not available generally) are permitted on buildings and other structures employed in the industry and individuals who are engaged in carrying on a business of primary production are allowed to average their incomes for taxation purposes. This is an obvious benefit having regard to our progressive rate system.

*Mining*
Development expenses, the cost of mine buildings, mining plant and other structures and housing for mine employees may be written off for tax purposes, generally over the shorter of the period of the expected life of the mine or five years. Expenditure associated with roads, railways and pipelines for the transport of mine products is deductible over ten years. Taxpayers may, at their option, elect not to utilise the mining provisions of the Act for deductions in respect of plant but may choose to rely on the normal depreciation allowances provisions. Costs of exploration for minerals or petroleum are fully deductible.

B. **Other commercial or industrial activities** subject to special tax treatment include:

Insurance companies
Shipping companies
Timber operations
Film businesses
Co-operative companies

### C. Investment allowance

A special deduction is allowed in computing taxable income where a taxpayer incurs expenditure on the purchase and installation of plant. The essential features of the investment allowance are:

- The plant must be *new* and used within Australia exclusively for the purpose of producing assessable income.
- The plant must be used by the owner or lessee of the plant. The allowance may be claimed by a leasing company, or by mutual agreement, the benefit may be passed on to the lessee.
- Plant acquired and installed ready for use between January, 1976 and June, 1979 qualifies for an investment allowance equal to 40 percent of the cost of the plant provided its construction or acquisition was under a contract entered into before 30th June, 1978. Plant finally completed and/or installed prior to 30th June, 1986 shall qualify for an allowance of 20 percent if the 40 percent criteria are not satisfied and provided the property was acquired under a contract entered into between January, 1976 and before July, 1985 or, where constructed by the taxpayer, construction commenced within that period.
- The legislation includes provisions to recapture the tax benefit granted if the plant is not used in accordance with the criteria or is disposed of within a relatively short period of time.
- The investment allowance is available in the year in which the plant is first used or installed ready for use. It is additional to normal tax depreciation allowances.

### D. Trading stock valuation adjustment

To reduce the impact of inflation on the financing of trading stock (inventories) the income tax law has been amended to provide a special deduction based upon the value at which the trading stock is brought to account for income tax purposes.

The stock valuation adjustment is measured by reference to the annual increase in the "goods" component of the consumer price index. For the first year of operation (1976/77) the adjustment allowed was 50 percent of the percentage increase in the said index value during the year from June, 1976 to June, 1977. The index increased by 10 percent during that period and accordingly a deduction equal to 5 percent of the opening value of trading stock was allowed in computing taxable income. It is the Government's stated intention to progressively phase in the adjustment to reflect, ultimately, the full percentage increase.

*Transfer of technology, know-how and managerial skills*
Exchange control approval is readily available for Australian enterprises which can demonstrate that operations they wish to conduct abroad create opportunities for the export of technology, know-how and managerial skills. The taxation system does not contain any special incentive provisions but Government assistance for export promotion and/or industrial research is available.

Apart from special treaty provisions, Australia does not offer fiscal advantages to overseas parties willing to benefit Australian industry by sharing technology, etc. Until recently visiting industrial experts were afforded a measure of local tax immunity but this is no longer so. In fact, the Australian legislation contains criteria for establishing the source of payments made to non-residents in consideration for technology, know-how and managerial skills. The effect of these provisions is to impose a tax upon non-residents deriving income from sources within Australia (as defined) notwithstanding that in ordinary parlance such income would not be considered to have its source in this country.

*A comparison of fiscal consequence of actions by the public and private sectors*

The doctrine of sovereign immunity is recognised in Australia and, as a consequence, the Governments of Australian States and any other country are afforded total exemption from any Australian taxes notwithstanding that they may have derived that income from sources in Australia and in competition with other taxpaying entities. This immunity from taxation extends to other organisations such as:

- Cultural, sporting and friendly societies.
- Trade unions and employer associations.
- Local Government and public authorities constituted under any Act or State Act or under any law enforced by a territory being part of Australia.
- Governmental and semi-Governmental superannuation funds.
- Superannuation funds (both local and foreign) Notwithstanding the opportunity for tax free enterprises to compete with taxpayer entities the commercial activities entered into by exempt bodies are normally of an investment or public utility nature leaving no room for claims of unfair competition.

## EVALUATION

Despite its vast land mass, Australia is one of the most urbanised countries of the world. The major cities are heavily populated; of a total population of approximately 14 million, over 60 percent is concentrated in the six capital cities. Sydney (over 3 million) and Melbourne (almost 3 million) accounting for more than 40 percent of the total population, are the largest urban communities. Most inland areas are relatively unpopulated and the continent includes extensive desert lands which are inhospitable and incapable of supporting rural or grazing pursuits. However most of the continent is yet to be explored for mineral deposits and already some substantial mining settlements have been established in remote areas of the continent.

Australia has for many years enjoyed stable Government and the conduct of business has fundamental characteristics common to both the British and American systems.

Whereas Australia continues to develop it is clear that programmes to encourage decentralisation have not been sufficiently attractive to overcome the physical and cultural disabilities involved in establishing homes and business activities in the Australian hinterland. The country is heavily dependant upon international trade and continues to rely heavily upon foreign investors to develop its industrial capacity. Although there has been little real growth in productive capacity during the past four years, with the rate of inflation now at a manageable level and business confidence quickly returning, a sustained period of economic growth is expected.

## LIST OF TAX TREATIES

**Concerning comprehensive double taxation treaties on income/capital**

**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Belgium * | income | October 13, 1977 | English, French and Dutch | AP treaties<br>SUPP. SER. Section C |
| Canada | income | October 1, 1959 | English | AP treaties |
| France | income | April 13, 1976 | English, French and Dutch | AP treaties<br>SUPP. SER. Section C |
| German Federal Republic | income, capital | November 24, 1972 | English and German | AP treaties<br>SUPP. SER. Section C |
| Japan | income | March 20, 1969 | English and Japanese | AP treaties<br>IX UN A (1) 274 |
| Netherlands | income | March 17, 1976 | English and Dutch | AP treaties<br>SUPP. SER. Section C |
| New Zealand | income | November 8, 1972 | English | AP treaties |
| Singapore | income | February 11, 1969 | English | AP treaties<br>Treaty Series, Vol. 708. p. 228 |
| United Kingdom | income | December 7, 1967 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A (1) 189<br>Treaty Series, Vol. 660, p. 88 |
| U.S.A. | income | May 14, 1953 | English | AP treaties |

* Not yet in force

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation).

SUPP. SER. Section C = Supplementary Service to European Taxation, Section C.

Treaty Series = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French, as the case may be.

UN = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes.

# INDONESIA:
# Tax Structure and Fiscal Policy

**by Prof. Dr. Rochmat Soemitro SH***

## I. THE TAX SYSTEM

### A. Introduction

The Indonesian tax system originated in the Dutch colonial period. After independence was proclaimed on August 17, 1945 the system was gradually modified and new taxes have been introduced, viz.:

a. turnover tax which after one year was replaced by sales tax;
b. development tax I;
c. transfer tax on real property;
d. transfer tax on motor vehicles;
e. dividend tax;
f. alien's tax.

Taxes are levied by both the central and local governments.

*Central government taxes:*

The Directorate General of Taxes administers the following taxes:

A. Direct taxes:
 1. Income tax (on individuals)
 2. Company tax
 3. Wealth tax (on individuals)

B. Indirect taxes:
 1. Stamp duties
 2. Sales tax on domestic products and services
 3. Tax on interest, dividends and royalties

The Directorate General of Customs and Excise administers:

1. Import and export duties
2. Excises on a. tobacco
 b. beer
 c. petrol
 d. sugar
 e. spirits
3. Sales tax on imported goods

*Local government taxes:*

1. Household tax **
2. Motor vehicle tax **
3. Transfer tax on motor vehicles **
4. Ireda (Tax on real estate) **
5. Alien's tax **
6. Development Tax I (on hotels and restaurants) **
7. Entertainment tax
8. Dog tax
9. Non-motor vehicle tax
10. Advertisement tax
11. Road tax
12. Slaughter tax

### B. Income tax

Subject to income tax are resident individuals irrespective of whether they are Indonesian citizens or aliens. Whether a person is resident in Indonesia is determined according to the facts. Liable to income tax is income derived from sources in Indonesia as well as income from sources outside Indonesia. If income is derived from abroad and liable to tax in the foreign country, a tax credit will be given according to the provisions of the tax treaty, if any. In case of no tax treaty, tax credit will be based on the unilateral relief provision (S.G. 1934 no. 291). In that case the credit allowable is the foreign income times the Indonesian tax rate.

Non-residents, irrespective of whether they are citizen or alien, are liable to Indonesian Income tax, if they derive income from sources in Indonesia, viz.:

a. immovable property situated in Indonesia;
b. loan secured by a mortgage on immovable property situated in Indonesia;
c. a profession or a business in Indonesia exercised or carried on either personally or through a representative or proxy;
d. any profit other than those indicated under (c) above from a profession or from a business in Indonesia, unless such profits are or will be subject to company tax;
e. a right to salary, leave pay, unemployment pay, cost of living allowances, pensions or other remuneration in respect of the performance of an office or employment, including any income paid from the public finances of Indonesia, or any pension from a business carried on in Indonesia.

A non-resident citizen not deriving any income from Indonesian sources is not liable to income tax. Non-resident taxpayers who receive income in the form of interest, dividends or royalties are liable to "tax on interest, dividends and royalties", a withholding tax at the source, which is a final tax.

*Personal allowances* (deductions) are only granted to resident taxpayers, as follows (year 1977):

| | |
|---|---|
| For the taxpayer himself ....... | Rp. 156,000.– |
| For his wife (or legal wives) ..... | Rp. 156,000.– |
| For each member or relative by blood or marriage in the direct line and foster children for whom the taxpayer is fully responsible, to the maximum of 5 persons ................. | Rp. 72,000.– |

* Lecturer at the Faculty of Social Science (on Tax administration & Public finance and Fiscal law), Assistant Professor at the Faculty of Economics (on Positive fiscal law), Padjadjaran University Bandung, and part time lecturer at the Faculty of Law, Gadjah Mada University.

** Formerly central government tax, transferred to local government. The proceeds of local taxes are not entered in the national budget.

Pension premiums are deductible to a maximum of 10 percent of the net income up to a maximum of Rp. 120,000.—. Life insurance premiums are also deductible, provided that when aggregated with pension premiums they do not exceed the above mentioned limit.

Gifts to charitable institutions as nominated by the Minister of Finance are deductible up to 3 percent of net income.

The *income tax rate* varies from 10 to 50 percent for taxable income above Rp. 9,600,000 (fiscal year 1978) which is lower than in preceding years.

Income tax is levied after termination of the fiscal year (generally calendar year) and the tax due is payable within one month after receiving the notice of assessment.

In the current year while waiting the final assessment the taxpayer carrying on a business is obliged to apply the *self assessment system,* i.e. to calculate himself the tax due at a prescribed percentage and deposit the amount so calculated in the State Treasury (MPS system). In fact this is a payment in advance. The rate is 2 percent turnover of trade and 5 percent of services.

The tax on salaries of civil servants and other remunerations paid from the treasury is guaranteed and paid by the government, which in fact is a payment of net salary or remuneration after tax.

*Individuals exempt from income tax:*

a. diplomatic and consular representatives of foreign countries and the staff assigned to them (on certain conditions);
b. the civil and military personnel of foreign armed forces;
c. the representatives of international organisations specified by the Minister of Finance.

## C. Company tax

Subject to company tax are resident companies as well as non-resident companies. Resident companies are companies incorporated in Indonesia under Indonesian Law.

Resident companies subject to company tax are:

a. companies or other associations the capital of which is wholly or partly divided into shares, viz. limited companies, cooperative bodies, limited partnerships which have issued shares etc.;
b. companies the capital of which is not divided into shares such as general partnerships;
c. foundations and other legal entities doing business.

Whether a company, partnership, association, foundation or body is domiciled in Indonesia is determined in accordance with the facts. Non-resident companies are liable to company tax if they carry on business through a permanent establishment situated in Indonesia. Profit is determined on an arm's length basis. Resident companies are liable to tax on worldwide income, with the possibility of tax credit for foreign tax.

*Tax rate*

20 percent for profit up to .......... Rp. 10,000,000
45 percent for profit exceeding .... Rp. 10,000,000

Distributed profits are taxed at a flat rate of 20 percent by withholding at the source (Tax on interest, dividend and royalties or TIDR). For resident taxpayers TIDR is in fact an advance payment of income tax or company tax which is creditable to income tax or company tax due. For non-resident taxpayers the TIDR is a final tax.

Company tax is payable within one month after receipt of notice of assessment.

For income derived abroad a unilateral relief provision is available, under which a tax credit is allowed. (Art. 8 Company Tax Law). If the income is derived from a country with which Indonesia has concluded a tax treaty, the provisions of the treaty will apply.

Company tax is often used as an instrument of development to give incentives to attract capital investments or to channel private savings to productive sectors, by giving tax holidays, investment allowances (deductions), accelerated depreciation etc.

*Shipping and aircraft business*

Since 1970 (by S.G. 1970-43) the provisions on the liability of income derived from foreign shipping and aircraft companies from international transport have undergone a complete revision. By virtue of the amended article (Art. 1a Company Tax Law) foreign companies maintaining international transport by sea or by air with Indonesian harbours or airports are liable to income tax. The taxable income was determined by ministerial decree (Kep. 579/MK/II/9/1972, Sept. 7, 1972) at 5 percent of the gross turnover, which afterwards was amended by the Director General of Taxation and fixed at 4.5 percent of the gross turnover.

By gross turnover is meant the total value of consideration in currency or the money value earned by the appropriate companies from the transport of persons and/or goods loaded between a port situated in Indonesia as well as between ports situated in and outside Indonesia.

Foreign shipping companies maintaining international sea transport are obliged to pay company tax by self assessment on a monthly basis of 2 percent from the gross turnover (formerly 4 percent) which is deemed to be equivalent to the company tax due (Tax rate times 5 percent times gross turnover). (Decree of the Director General of Taxes No. D.15.4-II-0222-10-1972/MPS-MPO).

Foreign aircraft companies maintaining international air transport with Indonesian airports must pay by self assessment a monthly company tax of 1½ percent (formerly 3 percent) of the gross turnover. (Decree of the Director General of Taxes No. D.15.4-II-0223-10-1972/MPS-MPO).

## D. Sales tax

Sales tax is levied on:

a. delivery of goods by manufacturers within the Indonesian customs area, within the scope of their business or profession;

b. importation of goods from abroad within the Indonesian customs area;
c. services rendered within the Indonesian customs area within the scope of their business or profession by entrepreneurs who are especially indicated in the Law.

The tax base is the selling price with regard to the delivery of goods and the consideration with regard to services. The standard tax rate is 10 percent, the reduced rate is 5 percent and the rate on luxury goods is 20 percent. Certain goods and services are exempt (zero rate). Entrepreneurs are obliged to calculate themselves the tax due and deposit the tax with the Treasury, within 10 days after the end of the calendar month for which tax has been incurred.

### E. Tax on interest, dividends and royalties (TIDR)

TIDR is levied on the proceeds, in whatever name or form,

1. derived from a loan of money *(interest)* to
   a. bodies domiciled and conducting business in Indonesia,
   b. individuals residing and conducting business in Indonesia,
   c. "permanent establishments" conducting business in Indonesia,
   d. the Central Government or local government in the form of bonds or treasury notes.
2. derived from shares, profit sharing certificates, and profit sharing bonds, issued by limited liability companies, partnerships which have issued shares, and other corporations domiciled in Indonesia, the capital of which is wholly or partly divided into shares *(dividend)*.
3. derived from a membership in a partnership or other bodies giving the right to share in the profit of these bodies which is not included in companies mentioned under no. 2, provided those bodies are subject to company tax.
4. derived from a patent, licence, trade mark and other rights and for the lease of industrial, commercial and scientific equipment and tools (in the form of *royalties*).

TIDR is in fact a withholding tax at the source and is due on the day of payment. The company which distributes dividends or pays interest or a royalty is authorized to withhold TIDR at a flat rate of 20 percent and deposit it with the Treasury within 30 days after the tax is due. TIDR for resident taxpayers is an advance payment of income or company tax. For non-residents TIDR is a final tax.

### F. Wealth tax (Property tax)

Wealth tax is imposed on the net wealth of individuals resident in Indonesia. Wealth consists of any property which can be valued in money terms. Property at the beginning of the year (generally calendar year) is decisive. The method of valuation of property is regulated by the law.

Exempt from wealth tax are diplomatic and consular representatives of foreign countries, the civil and military personnel of foreign armed forces and representatives of international organisations as specified by the Minister of Finance.

Non-residents are subject to wealth tax if they have any property in Indonesia which exceeds the limit of net wealth as specified by the Act.

## II. FISCAL POLICY IN INDONESIA

The generally accepted goal of fiscal policy is the attainment of greater economic stability, that is the maintenance of a reasonable stable rate of economic growth without development of substantial unemployment on the one hand or upward or downward movements in the general price level on the other.

In this context we would like to cite Prof. Dr. Soemitro Djojohadikoesoemo's article "Fiscal Policy, Foreign Exchange Control and Economic Development" (Majallah Ekonomi dan Keuangan Indonesia, April, 1954, page 213, 215) which says:

*"Fiscal policy as an instrument of development must therefore have a simultaneous purpose of directly finding the necessary funds for public investments or indirectly channeling private savings to productive sectors as well as of preventing the kind of spending that impedes development.*
*Summarily it can be stated that fiscal policy as an instrument of development must be based on a combination of progressivity in high direct and indirect taxation plus flexibility within the system for exemption and incentives to stimulate desirable private investments."*

Three important aspects of fiscal policy in Indonesia are:

a. taxation
b. expenditures
c. loans

The function of taxation is not merely taxation for revenue, but taxation is also used for purposes which are outside the financial sector. In addition, in developing countries taxation has apart from its budget function, an important role in their development, such as:

a. to regulate the level of income in the private sector,
b. to redestribute income,
c. to channel private savings into productive investments,
d. to prevent unproductive investments,
e. to promote development in a particular field, e.g. housing, tourism,
f. to protect domestic industries, domestic trade,
g. to stimulate exports,
h. to attract foreign capital,
i. to stimulate the transfer of technology, know-how and managerial skill.

We are fully aware that national development needs investments in large quantities in the public sector as well as in the private sector. This must be based on the capability, ability and aptitude of the Indonesian people itself. However, this must not lead to a reluctance to take advantage of the use of foreign capital, technology, skill and know-how available in developed countries, provided this will not result in a permanent dependency on foreign countries.

Investment must be financed directly from savings, public saving or private saving, or indirectly from loans. What policy is appropriate to create a favorable climate for investments? It is obvious that the increase of saving (public as well as private saving) will be most beneficial for greater investments.

The Indonesian government's policy in the public sector is to increase the budget surplus and by doing so public saving will increase too. To achieve this goal government revenue must be increased and simultaneously unnecessary government expenditures must be curbed and a tight control accomplished. Because new taxes are not introduced, the collection of existing taxes is intensified, the number of tax officials increased accordingly, the technical skill enhanced and the infrastructure improved.

Indonesian soil and the continental shelf adjacent to Indonesian territory is rich in mineral and oil resources which is explored and exploited for the benefit of the Treasury. State revenue shows a steady increase (see tables I, II, III and IV).

From the figures one may observe that direct tax in Indonesia plays an important role in revenue. Where in 1972/73 direct tax constituted only 51.16 percent of total revenue, it increased gradually, respectively, to 52, 70, 71 and 68 percent in the years 1973/74, 1974/75 and 1975/76. In the framework of direct taxes company tax on oil takes a special position.

Public investments are aimed at financing projects which are not attractive to private investors, e.g. road and bridge construction, irrigation, the building of dam infrastructure etc.

In this context it is worht mentioning that the government has invested large amounts in state enterprises. A state enterprise is a business enterprise which is incorporated by the government and the shares of which are wholly in the hands of the government. The legal form could be a:

a. Perusahaan Jawatan (PERJAN) — governmental or departmental agency or enterprise doing business which constitutes a unit of the government;
b. "Perusahaan UMUM" (PERUM) — a corporation incorporated under a particular law (Law no. 19 of 1960);
c. "Perusahaan Perseroan" (PERSERO) — a public company which is established under the ordinary company law.

State enterprises are designed to have a leading position in the business world and to be active in fields which are not attractive to private investors.

Public saving coupled with foreign loans via the IGGI, foreign aid and domestic loans have made a tremendous investment in the public sector in the last decade (PELITA I and PELITA II, Indonesian 5 year plan) (see table I).

In the private sector the role of the government is rather complicated, because it has no right to decide the use of private saving for private investments. But is has to convince the private savers of the gigantic efficacy of investment in development and it has to persuade capital owners to be willing to invest their money in projects of development, by giving all kinds of incentives. Taxation, for instance, is used as an instrument to give attractive facilities.

Law no. 1 of 1967 has been promulgated to make private investment more interesting by giving certain tax facilities to companies which are incorporated under Indonesian law by foreign capital owners, and willing to be active in a particular field getting priority from the government viz.:

a. exemption from capital stamp duty on paid-in capital;
b. tax holiday for a maximum period of 6 years;
c. investment allowances (deductions);
d. accelerated depreciation;
e. exemption from dividend tax;
f. exemption from sales tax on imported capital goods;
g. exemption from transfer duties on ships;
h. carry over of initial loss sustained during the tax holiday period to the following years without limit;
i. carry over of any other loss to the 4 following years;
j. in concluding tax treaties for the avoidance of double taxation with developed countries, Indonesia endeavors to have the "tax sparing" clause accepted by the industrial countries, which means a benefit for the capital owners with regard to taxation in their home country.

Non-tax incentives are also made available which, for example, allow the transfer of accumulated profit (after tax) to the home country and the repatriation of the invested capital after a certain period.

On the other hand taxation is also used as an incentive to attract domestic capital by giving the same facilities as mentioned above (Law no. 6 of 1968).

In addition, small capital owners who are not able to participate directly in big investments are given an incentive to save their money in the government's bank or to put the money in time deposit or to buy bank certificates for which they will receive an attractive rate of interest varying from 1½ to 2 percent monthly. Besides the monetary policy, fiscal policy makes saving even more attractive by giving the following incentives:

a. interest received is exempt from income tax;
b. no tax on interest, dividends or royalties;
c. money saved is not deemed to be property liable to wealth tax;
d. no further investigation on the origin of money and there will be no tax repercussions for previous years.

Fiscal policy recently has also been applied to revive the capital market by granting tax facilities for the sale or purchase of shares via the stock exchange. In order to give to small capital owners the possibility to participate in investments, the government has established an intermediary company (P.T. Danareksa) with an equity

## TABLE I

**State Budget in billion Rupiah**

| | 1972/73 | 1973/74 | 1974/75 | 1975/76 | 1976/77 Semester I | 1977/78 Planning | |
|---|---|---|---|---|---|---|---|
| Direct Tax | 302.2 | 505.0 | 1,228.7 | 1,592.1 | 861.1 | 2,497.1 | |
| Indirect Tax | 253.8 | 412.9 | 458.4 | 539.4 | 353.1 | 898.2 | |
| Non Tax | 34.6 | 49.8 | 66.6 | 110.4 | 47.6 | 83.9 | Budget: |
| STATE REVENUE | 590.6 | 967.7 | 1,753.7 | 2,241.9 | 1,261.8 * | 3,484.2 | * 2,803.2 |
| EXPENDITURE | 438.1 | 713.3 | 1,016.1 | 1,332.6 | 673.7 ** | 2,079.4 | ** 1,600.3 |
| PUBLIC SAVING | 152.5 | 254.4 | 737.6 | 909.3 | 588.1 | 1,404.8 | 1,202.9 |
| FOREIGN AID | 157.8 | 203.9 | 232.0 | 491.6 | 377.9 | 763.1 | |
| a) Program aid | (95.5) | (89.8) | (36.1) | (20.2) | ( 2.3) | (35.6) | |
| b) Project aid | (62.3) | (114.1) | (195.9) | (471.4) | (375.6) | (727.5) | |
| DEVELOPMENT FUND | 310.3 | 458.3 | 969.6 | 1,400.9 | 966.0 | 2,167.9 | |
| DEVELOPMENT EXPENDITURES | 298.2 | 450.9 | 961.8 | 1,397.7 | 778.3 | n.a. | |
| BALANCE | + 12.1 | + 7.4 | + 7.8 | + 3.2 | + 187.7 | | |

## TABLE II

**Direct taxes in billion Rupiah**

| | 1972/73 | 1973/74 | 1974/75 | 1975/76 | 1976/77 Semester I |
|---|---|---|---|---|---|
| 1. Income tax | 23.7 | 34.4 | 43.3 | 61.7 | 39.1 |
| 2. Company tax | 30.6 | 44.2 | 91.2 | 128.2 | 54.5 |
| 3. Oil Company tax | 198.9 | 344.6 | 973.1 | 1,249.1 | 671.0 |
| 4. M.P.O. (withholding tax) | 30.2 | 56.8 | 83.3 | 97.3 | 62.4 |
| 5. IPEDA (Real property tax) | 15.2 | 19.5 | 28.0 | 34.6 | 23.2 |
| 6. Others | 3.6 | 5.5 | 9.8 | 21.2 | 10.9 |
| DIRECT TAXES | 302.2 | 505.0 | 1,228.7 | 1,592.1 | 861.1 |

## TABLE III

**Indirect taxes in billion Rupiah**

| | 1972/73 | 1973/74 | 1974/75 | 1975/76 | 1976/77 Semester I |
|---|---|---|---|---|---|
| 1. Sales tax | 34.5 | 54.6 | 84.9 | 119.2 | 75.1 |
| 2. Sales tax on imports | 27.8 | 50.7 | 68.9 | 72.5 | 50.0 |
| 3. Excise | 47.3 | 61.7 | 74.4 | 97.3 | 59.1 |
| 4. Import duties | 73.2 | 128.2 | 160.6 | 174.0 | 126.1 |
| 5. Export duties | 32.7 | 68.6 | 70.3 | 61.6 | 26.8 |
| 6. Other proceeds from oil | 31.6 | 37.6 | −15.9 | − 1.1 | 11.4 |
| 7. Others | 6.7 | 11.5 | 15.2 | 15.9 | 4.6 |
| INDIRECT TAXES | 253.8 | 412.9 | 458.4 | 539.4 | 353.1 |

**TABLE IV**

**State revenue in billion Rupiah**

| | 1972/73 | 1973/74 | 1974/75 | 1975/76 | 1976/77 Semester I | 1977/78 Planning |
|---|---|---|---|---|---|---|
| DIRECT TAX | 302.2 | 505.0 | 1,228.7 | 1,592.1 | 861.1 | 2,497.1 |
| INDIRECT TAX | 253.8 | 412.9 | 458.4 | 539.4 | 353.1 | 898.2 |
| NON TAX | 34.6 | 49.8 | 66.6 | 110.4 | 47.6 | 88.9 |
| | 590.6 | 967.7 | 1,753.7 | 2,241.9 | 1,261.8 | 3,484.2 |

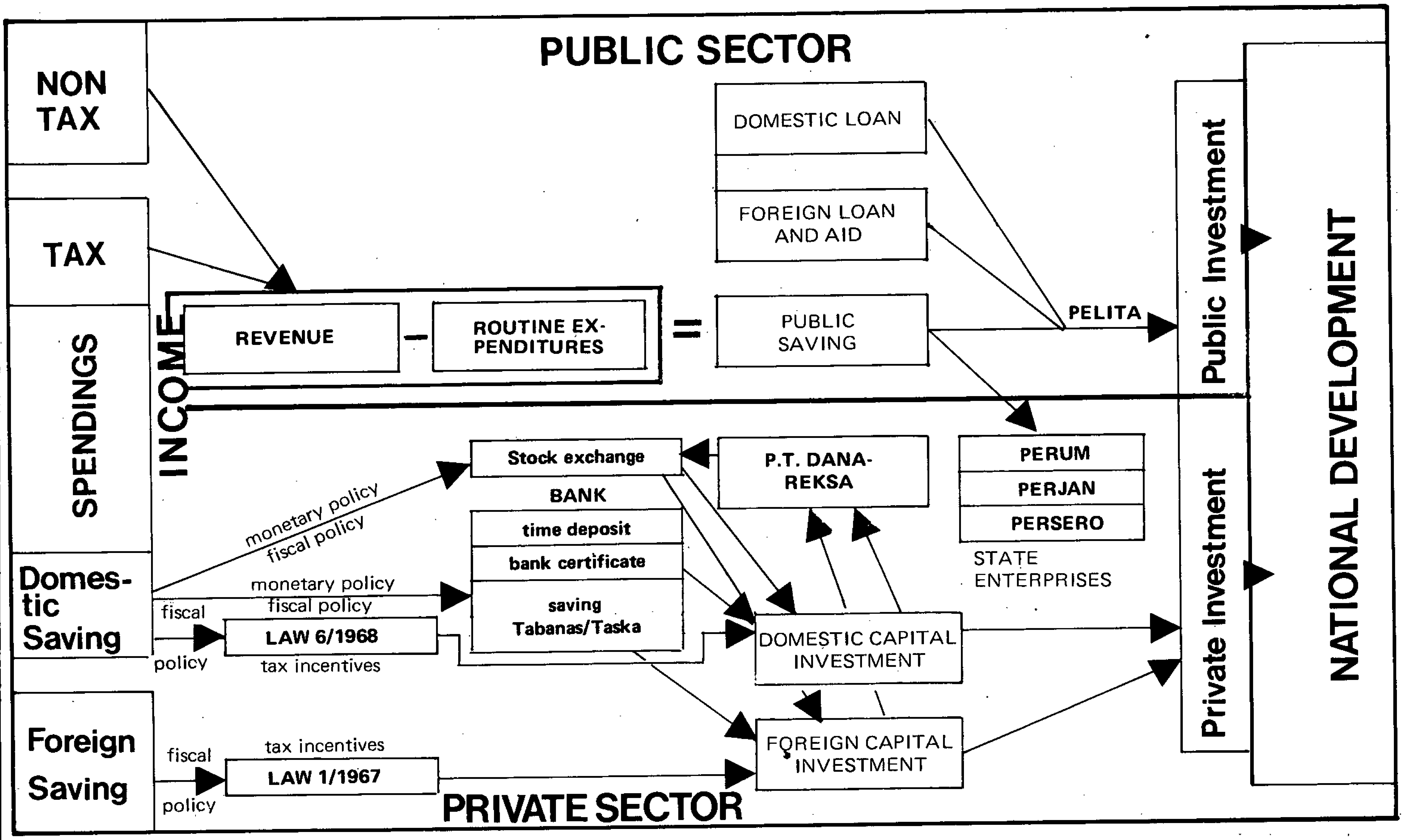
capital of 50 billion Rupiah, whose aim is to buy stock of bona fide corporations which in turn will be broken down into small share certificates which are within the financial reach of the small capital owners. The purchase of such share certificates at the stock exchange qualifies for the tax facilities which have been given to the private savers mentioned above.

Companies which in accordance with the regulations sell their shares via the stock exchange have the right to revalue once their fixed assets in accordance with the provisions given by the law. The increase of nominal capital as a result of revaluation will not be deemed to be taxable income. Depreciation is allowed on the revalued value. No capital stamp duty is due, if the increased capital is used for the issuance of new shares (bonus shares). In addition, the bonus shares will be exempt from TIDR nor will they constitute taxable income for the recipient (Min. Decree Kep. 1677/MK/II/12/1976 December 28, 1976).

Fiscal policy does not discriminate between foreign and domestic investors. They are treated in the same manner with respect to any facilities and the tax burden imposed. Tax facilities have been extended to companies whose activities are in the hotel business, agriculture, forestry, fishery, communications, tourism, industry and housing.

Mining companies engaged in oil drilling activities enjoy special treatment and the taxable income of oil drilling companies is by decree of the Minister of Finance (no. Kep. 914/MK/II/1973 of September 4, 1973) determined on 10 percent of the gross income. The payment of company tax is simplified, no tax assessment will be be issued but the amount of tax is embodied in the articles of "Contract of work" with Pertamina. Pertamina receives on behalf of the government the payment of tax due in the form of crude oil together with Pertamina's allotment of the proceeds. In turn Pertamina has to deposit the tax in money terms to the Treasury.

With regard to non-oil and non-gas mining companies a government regulation (No. 21 of 1976) provides provisions in which it is stipulated that during 10 years after the first commercial production, company tax at a reduced rate of 35 percent will be imposed. After termination of the 10 year period the normal rate of 45 percent will be applied. TIDR at a reduced rate of 10 percent must be withheld which is effective for a period equal to the term of mining rights not exceeding 30 years. Capital stamp duty, import duties and sales tax on imported capital goods are also exempt on certain conditions. Carry over of losses sustained, accelerated depreciation and investment allowances are other facilities which benefit non-oil and non-gas mining companies. Finally loans have been made available to small manufacturers or entrepreneurs or to persons who intend to build dwelling houses.




## LIST OF TAX TREATIES

**Concerning comprehensive double taxation treaties on income/capital**

**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Belgium | income, capital | November 13, 1973 | English | AP treaties<br>SUPP. SER. Section C<br>BP |
| German Federal Republic * | income, capital | September 2, 1977 | German, English and Indonesian | AP treaties |
| Netherlands | income, capital | March 5, 1973 | Dutch, English and Indonesian | AP treaties<br>SUPP. SER. Section C<br>BP |
| United Kingdom | income, capital | March 13, 1974 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 350<br>BP |

* Not yet in force.

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation).
SUPP. SER. Section C = Supplementary Service to European Taxation.
UN = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes.
BP = Berita Pajak, Jakarta, English edition.

# PHILIPPINES: Tax Structure and Fiscal Policy

by Dr. Angel Q. Yoingco*

## I. CATALOGUE OF TAXES IMPOSED AT THE NATIONAL LEVEL

### A. Taxes on goods and services

1. Sales tax is a percentage tax on all goods sold or exchanged in the Philippines whether domestically manufactured or imported *except* the following: (a) articles subject to specific tax; (b) certain agricultural products; (c) minerals and mineral products; (d) articles exported; (e) articles subject to the miller's tax.

Tax rates vary from 5, 7, 15, 40 to 70 percent. Granted rates of 10-70 percent are imposed on domestically manufactured automobiles and from 100-200 percent on imported automobiles, depending on price grouping.

2. Specific tax is imposed on liquor, tobacco, wine, matches, gasoline, etc. at specific rates per commodity per unit of quantity, volume capacity, etc.

3. Privilege tax on business is imposed on all services rendered in the Philippines by contractors, proprietors or operators of dockyards and others at 3 percent, caterers at 3-20 percent, and carriers at 2 percent, all based on gross receipts.

### B. Taxes on international trade

1. Export tax and premium duty — export tax is imposed on wood products, mineral products, plant and vegetable products and animal products for export at rates ranging from 4-10 percent of gross F.O.B. value. Premium duty is an additional imposition at 20-30 percent.

2. Import duties are imposed on imported goods at varying rates ranging from 10-100 percent ad valorem.

### C. Transfer taxes

1. Estate tax is imposed on the net estate of a decedent (progressive brackets) at its fair market value at 3-60 percent.

2. Donor's tax is imposed on the net taxable gift (progressive brackets) at its fair market value at 1.5-40 percent.

### D. Tax on property

1. Real property tax (a local tax) is imposed on the assessed value of real estate, land and improvements at 0.25-2 percent. An additional tax of 1 percent on real property is also imposed which accrues to the special Education Fund, a nationally administered fund.

### E. Taxes on income

*1. Personal income tax*

| | *Persons liable* | *Tax base* | *Minimum and maximum rates* |
|---|---|---|---|
| (1) | Resident citizens and aliens | Worldwide net income | 3-70 percent |
| (2) | Non-resident citizens | Domestic net income | 3-70 percent |
| | | Adjusted gross income from sources outside the Philippines | 1-3 percent |
| (3) | Non-resident aliens engaged in trade or business | Domestic net income | 3-70 percent |
| (4) | Non-resident aliens *not* engaged in trade or business | Domestic gross income | 30 percent |
| (5) | Alien executives, employees of regional or area headquarters of multinationals in the Philippines | Domestic gross | 15 percent |

*2. Corporate income tax*

| | *Persons liable* | *Tax base* | *Minimum and maximum rates* |
|---|---|---|---|
| Domestic corporations | | | |
| (1) | Ordinary corporations | Worldwide net income | 25-35 percent plus 5 percent development tax if global net income exceeds 10 percent of net worth |
| (2) | Family corporation | World-wide net income | 25-35 percent plus 5 percent development tax regardless of rate of return on net worth |
| (3) | Private educational institutions | Net income from operation of schools and passive investments | 10 percent plus 5 percent condition in No. 1 above |
| (4) | Ordinary and family corporations, private educational institutions | Dividends received from a domestic corporation liable to tax | 10 percent |

* Executive Director of the National Tax Research Center.

Foreign corporations

| | | |
|---|---|---|
| (1) Resident corporations | Domestic net income | 25-35 percent plus 5 percent development tax if net income exceeds 10 percent of net assets in the Philippines |
| | Dividends received from a domestic corporation liable to tax | 10 percent |
| (2) Foreign international carriers | Gross Philippine billings | 2.5 percent |
| (3) Branches except those registered with Export Processing Zone | Remitted profits | 15 percent |
| (4) Non-resident corporations | Domestic gross income | 35 percent |
| | Interest on foreign loans | 15 percent |
| | Dividends received from a domestic corporation liable to tax, under tax sparing provision | 15 percent |
| (5) Cinematographic film owners, lessors and distributors | Domestic gross income | 25 percent |
| (6) Offshore banks | Net offshore income | 5 percent |
| | Other net offshore income | 25-35 percent |
| | Interest income from domestic loans | 10 percent |

### F. Other national taxes

1. Motor vehicle tax is imposed on vehicles based on weight and type of vehicle, at the following amounts; (1) privately-owned automobiles — basic of ₱110 to ₱630 plus additional tax at nominal amounts; (2) others at basic of ₱5.00 to ₱50.00 plus additiona tax at nominal amounts.

2. Stamp taxes (documentary stamp tax and science stamp tax) — amount of tax varies with the type of document.

3. Energy tax is levied on vehicles (0.5-2 percent based on a schedule to be prepared by Secretary of Finance), aircraft (₱1,050-₱2,100) and motorcraft used for pleasure and recreation (₱1,000-₱16,000).

4. Mining taxes are imposed at 2 percent ad valorem of the actual market value of annual gross output of minerals or mineral products.

5. Miscellaneous taxes on banks (5 percent of gross receipts); finance companies (1 percent of gross receipts); insurance premiums (ad valorem tax of 3 percent and 5 percent of total premiums collected); amusement (ad valorem imposed on gross receipts).

6. Others, such as franchise tax, charges on forest products, water rentals, tobacco inspection fees, firearms tax, residence tax and immigration tax at various nominal rates.

### G. Total revenue from each tax broken down into percentages of total revenue and GNP

See Appendix A.

## II. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, WEALTH, ESTATE AND GIFTS

### A. Domestic and foreign investments

The Philippines pursues a policy of attracting and stimulating domestic and foreign investments both by tax and non-tax incentives. The policy is one of mutual cooperation and harmonization of all investments with development objectives. There are no wealth taxes. The income, profit remittance, estate and gift taxes compare well with those imposed by countries in the Asia-Pacific region and are designed to give government its due share without unnecessarily imposing an undue burden on domestic and foreign investors. (For information on the tax base and tax rates, see (I) above.) Incentives are also given in pursuit of this policy. The major incentives are listed below:

| *1. Tax incentives* | *Practical effects* | *Relevant laws/ Decrees* |
|---|---|---|
| a. Exemption from income tax | Tax holiday | RA 5186, as amended<br>RA 6135, as amended<br>PD 1159; PD 8, as amended;<br>PD 535; PD 215 as amended<br>PD 538; PD 66<br>RA 387, as amended<br>CA 137, as amended<br>RA 3470, as amended<br>PD 237; PD 463; PD 238 |
| b. Deductions from income (e.g., organization and preoperating expenses; net operating loss carry-over; accelerated depreciation; 50 percent of labor | Reduced income tax | RA 5186, as amended<br>RA 6135, as amended<br>PD 1159; PD 8 as amended<br>PD 1167 |

| | | |
|---|---|---|
| training expenses under conditions; investment actually made; expansion re-investment; sum of direct labor cost and raw materials utilized in manufacture of export products under conditions) | | |
| c. Tax credits (e.g. 100 percent of compensating tax and customs duties that would have been paid on capital goods (purchased from domestic manufacturers) had these been imported; taxes withheld on interest payments on foreign loans under conditions; 100 percent of infrastructure works in areas designated for industry dispersal or in areas defifient in infrastructures) | Reduced income tax | RA 5186, as amended<br>RA 6135, as amended<br>PD 1159;<br>PD 1167 |

| 2. *Non-tax Incentives* | *Practical effects* | *Relevant laws/ Decrees* |
|---|---|---|
| a. Protection of patents and other proprietary rights | Guaranted income | RA 5186, as amended<br>RA 6135, as amended |
| b. Employment of foreign nationals in supervisory, technical or advisory position within 5 years from date of operation | Employment opportunity | RA 5186, as amended<br>RA 6135, as amended |
| c. Anti-dumping protection | Protection from competition from foreign markets | RA 5186, as amended<br>RA 6135, as amended |
| d. Preference in grant of loans by government financial institutions | Easy credit | RA 5186, as amended<br>RA 6135, as amended |
| e. Protection from government competition | Viability of industry | RA 5186, as amended<br>RA 6135, as amended |

## B. Domestic and foreign trade

The government's policy has been and will be towards promotion and development of domestic and foreign trade. To realize this policy, the government has granted various tax and non-tax incentives. There are also promotional programs undertaken by the concerned government agencies to further the trade sector such as participation in fairs, trade missions, establishment of Philippine Houses abroad.

| 1. *Foreign trade: Tax incentives* | *Practical effect* | *Relevant laws/ Decrees* |
|---|---|---|

Refer to II.A.Domestic and foreign investments, above.

| 2. *Foreign trade: Non-tax incentives* | *Practical effect* | *Relevant laws/ Decrees* |
|---|---|---|

Refer to II.A.Domestic and foreign investments, above.

| 3. *Domestic trade: Tax incentives* | *Practical effect* | *Relevant laws/ Decrees* |
|---|---|---|
| a. Refer to II.A.Domestic and foreign investments, above. | | |
| b. Cooperatives: | | |
| (i) Exemption from income taxes under conditions | Tax holiday | PD 175 |

4. *Domestic trade: Non-tax incentives*

(i) Marketing assistance to NACIDA-registered enterprises by enjoining all departments, bureaus, offices, government-owned or controlled corporations to buy supplies from cottage industries (Letter of Instruction 83).

(ii) Promotion and marketing of products mainly of small and medium-scale industries, farmers and investors through the Trade Assistance Center of the Department of Trade.

## C. Transfer of technology, know-how and managerial skills

The country welcomes foreign investments and the accompanying transfer of technology, know-how and managerial skills. This policy is obvious in the grant of tax and non-tax incentives to facilitate such transfer, to wit:

1. Tax exemption of salaries and stipends in dollars received by aliens solely and by reason of services rendered under certain international organizations, e.g. International Rice Research Institute, etc. (RA 3538, as amended)

2. For aliens employed in regional or area headquarters of multinationals (PD 218):

a. issuance of miltiple entry special visa
b. exemption from securing alien certificates of registration
c. exemption from obtaining emigration clearance

certificates and other types of clearance required by government

d. exemption from customs duty and compensating tax of imported motor vehicle

e. reduced tax of 15 percent on gross income

**D. Diversification and selectivity**

1. Countries from which investment, etc. is solicited: The Philippines welcomes investment, technology, etc. from any source as long as these meet development objectives.

2. Types or areas of investment, trade, etc.: Various types of tax and non-tax incentives are given to registered or pioneer enterprises, to preferred areas of investment, etc. (refer also to (II)(A) for incentives under RA 5186, RA 6135, PD 1159).

**Special measures to promote industrial development**

| *Sector* | *Incentives* | *Relevant laws/ Decrees* |
|---|---|---|
| (i) Mining Industry | Exemption from the payment of all taxes except income tax for five years under conditions | CA 137, as amended |
| (ii) Cottage Industry | Exemption from all taxes except specific tax, income tax, compensating tax and customs duties for a period of five years under conditions | RA 3470, as amended |
| (iii) Rural Bank | Exemption from the payment of all taxes, charges and fees of whatever nature and description except income tax, compensating tax and customs duty | RA 720, as amended |
| (iv) Private Development Bank | Exemption from the payment of all taxes, charges and fees of whatever nature and description, including income tax, except compensating tax and customs duties under conditions | |
| (v) Registered enterprise; Pioneer enterprise | Incentives under this law include tax and non-tax incentives to industries and investors in such designated area of economic activity | RA 5186, as amended |
| (vi) Oil exploration and development | (1) Exemption from all taxes (except income tax), tariff duties and compensating tax on the importation of machinery and equipment, etc., under conditions (2) Exemption upon approval by the Petroleum Board from laws, regulations or ordinances restricting the (a) construction, installation and operations of power plants, (b) exportation of machinery and equipment which were imported solely for its operation when no longer needed (3) Exportation of petroleum subject to the prior filling of domestic needs (4) Entry of alien technical and specialized personnel for the operation of the contractor (5) Repatriation of capital and retention of profits abroad. (6) Deduction from taxable income of Filipino participation and reimbursement of operating expenses including amortization (7) Exemption from customs duty and compensating tax under conditions on importation of machinery, equipment, etc. by petroleum exploration concessionaires or their contractors or sub-contractors | RA 387, as amended |

| | | |
|---|---|---|
| (vii) Area or regional headquarters of multinational companies | (1) Exemption from all forms of local taxes, licenses fees, and impost (2) Exemption from the 3 percent contractor's tax | PD 218, as amended |

*3. Regional or special areas*

Regarding the policy on *industry dispersal*

a. no new firm or industry is allowed within a fifty (50) kilometer radius of Manila;

b. to a registered export producer who establishes his manufacturing plant in an area designated by the Board of Investments, additional incentives are given, to wit: (1) an amount equivalent to double the direct labor cost for reduced income tax and (2) an amount equivalent to 100 percent of necessary infrastructure works undertaken by the registered export producer can be used to apply to payment of national taxes.

c. Industrial estates have also been created to further investment objectives, like the Export Processing Zone Authority (EPZA) and the Agro-Industrial Complex within the Food Terminal Area. The following laws give tax and non-tax incentives to industrial estates:

(i) RA 5186, as amended (Refer to (II)(A) above)
(ii) RA 6135, as amended (Refer to (II)(A) above)
(iii) PD 66, (Refer to (II)(A) above)

## E. Difference in treatment (if any) between public and private sector

The basic economic orientation of the Philippines has always been toward free enterprise. As a result, once a business is established it is allowed to operate with the minimum degree of government regulation. However, the government may also engage in a business undertaking where the interest of the general public requires it as in the case of transportation, grains procurement, etc. These are cases where the private sector cannot adequately meet public needs.

# III. ORIENTATION OF FISCAL POLICY: SALES TAXES, ETC.

## A. Distribution of wealth

The government pursues a policy of wealth and income (re)distribution in order to spread more equitably benefits of progress. The indirect tax system (sales taxes, excise taxes, customs duties) is extensively used to meet this goal by means of higher taxes on commodities commonly consumed by the rich, on non-essential goods, etc.

| *Features* | *Practical effects* | *Relevant laws/ Decrees* |
|---|---|---|
| 1. Increased specific taxes on alcoholic beverages | Increased tax | PD 1158 |
| 2. Higher tax rates for processed fruits like peaches, cherries, etc. | Increased tax | PD 1158 |
| 3. Higher tax rates on winnings in Jai-Alai and horse racing | Increased tax | PD 1158 |
| 4. Differentiated tax rates on ordinary, semi-luxury and luxury articles | Increased tax on luxuries<br>Lower tax on ordinary articles | CA 466, as amended |
| 5. Lower tax rates on basic commodities | Tax relief | CA 466, as amended |
| 6. Various tax exemptions | Tax holiday | Refer to (II)(A) above |
| 7. Tax credits | Reduced tax | Refer to (II)(A) above |

## B. Employment

The thrust of government policy is to harness gainfully the abundant manpower in the country. Towards this end various measures to stimulate and create labor intensive industries were adopted.

| *Tax Incentives* | *Practical effects* | *Relevant laws/ Decrees* |
|---|---|---|
| 1. Deduction of labor training expenses | Reduced income tax | RA 5186, as amended<br>RA 6135, as amended<br>PD 1159<br>PD 1167 |
| 2. Exemption from all taxes under the NIRC except the income tax | Tax holiday | RA 5186, as amended<br>RA 6135, as amended |
| 3. Exemption from customs duties, internal revenue and local taxes of foreign or domestic merchandise, raw materials, supplies, equipments, and all other items necessary for the | Tax holiday | PD 66, as amended |

| | | |
|---|---|---|
| assembly or manufacture of products inside the Export Processing Zone | | |
| 4. Exemption from export tax | Tax holiday | RA 6135, as amended |
| 5. Exemptions from all taxes, except specific and income taxes under certain conditions of the registered person or firm engaged in the production or manufacture of cottage industry products. | Tax holiday | RA 3470, as amended |

### C. Regional development

The government creates, supports and strengthens institutions in various regions of the country and provides incentives to carry out regional development. Self-reliance among local government units is also a primary objective. To realize these goals, the government passed various measures, as follows:

| *Features* | *Practical effects* | *Relevant laws/ Decrees* |
|---|---|---|
| 1. Exemption from customs duties, internal revenue and local taxes of foreign or domestic merchandise, raw materials, supplies, equipments, and all other items necessary for the assembly or manufactured of products inside the Export Processing Zone (Bataan) | Tax holiday | PD 66, as amended |
| 2. Exemption of local water district system from payment of all taxes | Tax holiday | PD 198 |
| 3. Exemption from payment of all taxes of cooperatives (such as Samahang Nayon) | Tax holiday | PD 175 |
| 4. Exemption from all taxes of electric cooperatives and the National Electrification Administration | Tax holiday | PD 269, as amended |
| 5. Exemption from all taxes of various regional development authorities | Tax holiday | RA 4412; RA 6080; RA 3856; RA 4132; PD 625, as amended; PD 690, as amended; RA 4850 |

## IV. ORIENTATION OF FISCAL POLICY: OTHER (NON-TAX) FIELDS

A. The country provides other non-tax incentives to domestic and foreign investments in the form of special low interest loans, various infrastructure supports, etc. The following sectors are recipients of these non-tax incentives:

1. Agriculture, fishery, livestock and forestry
2. Industrial
3. Utilities
4. Commercial
5. Firms under the Export Processing Zone Authority (EPZA)

### B. Providing infrastructure in particular areas (e.g., industrial estates)

1. Refer to (II)(D) above on discussion of industry dispersal and (II)(A) for tax and non-tax incentives to industrial estates like the EPZA.

2. The EPZA is also empowered to construct, acquire, own, lease, operate and maintain infrastructure facilities within their respective areas.

### C. Others (e.g., free trade zone and allied facilities)

1. Refer to (II)(A) on discussion of free trade zones.

2. Other non-tax incentives granted under PD 66 creating the EPZA

a. Priority in allocation of foreign exchange to zone registered enterprises and in the availment of assistance and resources of Central Bank under conditions.

b. EPZA-registered enterprises are entitled to the same privileges given to enterprises approved and registered with B I under RA 4860, as amended by RA 6142 or under any existing law, order, rule or regulation or which may hereafter be enacted with respect to availment of loans, credits, etc. from government financial institutions.

## V. EVALUATION

It is hard to assess in definitive terms whether and to what extent policy goals set have been achieved due to other interplaying forces which influence the achievement or non-achievement of such goals. However, there are a number of encouraging signs which point to the effectiveness of the system of incentives to achieve policy goals. Available statistics at least on the Investment Incentives Act (RA 5186, as amended) and the Export Incentives Act (RA 6135, as amended) show growth figures for the number of registered projects, value of actual investments, employment, export earnings, etc. (see Appendix A).

On the negative side, availment of these incentives has cost the government revenue losses. According to the Bureau of Internal Revenue, estimated tax loss due to deductions from taxable net income alone amounted to as much as ₱815.3 million (approximately US$119.9 million) from 1970-1976.

By and large, it may be safe to say that the system of incentives has influenced to a great extent the achievement of policy goals; thus, incentives will always be a cornerstone of development programs. The government, however, maintains an attitude of openness and pursues a policy of flexibility such that incentives will be continuously studied and designed to suit policy goals.

### APPENDIX A

| | | Revenue collections by type of tax (in M₱) | | As percent of total revenue | | As percent of GNP | |
|---|---|---|---|---|---|---|---|
| | | CY 1975 | CY 1976 | CY 1975 | CY 1976 | CY 1975 | CY 1976 |
| Direct taxes | Taxes on income | 3,073.8 | 3,704.8 | 18.85 | 21.78 | 2.69 | 2.86 |
| CY '75 - ₱3,192.2M | Corporate income tax | 1,954.1 | 2,222.3 | 11.98 | 13.07 | 1.71 | .72 |
| CY '76 - ₱3,820.1M | Personal income tax | 1,197.7 | 1,482.5 | 6.81 | 8.72 | 0.98 | 1.14 |
| | Transfer taxes | 24.3 | 28.1 | 0.15 | 0.17 | 0.02 | 0.02 |
| | Real property tax (SEF) | 91.2 | 84.1 | 0.56 | 0.49 | 0.08 | 0.06 |
| | Immigration tax | 0.6 | 0.8 | .01 * | .01 * | .01 * | .01 * |
| | Residence tax | 2.3 | 2.3 | .01 | .01 | .01 | .01 |
| Indirect taxes | Taxes on goods & services | 5,154.2 | 5,594.1 | 31.60 | 32.89 | 4.52 | 4.32 |
| CY '75 - ₱11,209.0M | Sales tax | 1,552.6 | 1,618.0 | 9.52 | 9.51 | 1.36 | 1.25 |
| CY '76 - ₱10.871.2M | Specific tax | 2,453.3 | 2,529.9 | 15.04 | 14.88 | 2.15 | 1.95 |
| | Other taxes on goods and services | 1,148.3 | 1,446.2 | 7.04 | 8.50 | 1.01 | 1.12 |
| | Franchise tax | 71.1 | 68.5 | .44 | .40 | 0.06 | 0.05 |
| | Wharfage fees and other dues | 131.0 | 136.7 | .80 | .80 | 0.12 | 0.11 |
| | License, business and occupation tax | 946.2 | 1,241.0 | 5.80 | 7.30 | 0.83 | 0.96 |
| | Taxes on international trade | 5,464.0 | 4,784.3 | 33.50 | 28.13 | 4.79 | 3.69 |
| | Import duties | 4,041.9 | 4,220.6 | 24.62 | 24.82 | 3.52 | 3.26 |
| | Export tax & premium duties | 1,449.1 | 563.7 | 8.88 | 3.31 | 1.27 | 0.43 |
| | Other national taxes | 410.8 | 492.8 | 2.52 | 2.90 | 0.36 | 0.38 |
| | Stamp taxes | 211.2 | 241.1 | 1.29 | 1.42 | 0.18 | 0.19 |
| | Science stamp tax | 99.0 | 116.4 | .60 | 0.68 | 0.08 | 0.09 |
| | Documentary stamp tax | 112.1 | 124.7 | .69 | 0.73 | 0.10 | 0.10 |
| | Motor vehicle taxes | 167.7 | 191.6 | 1.03 | 1.13 | 0.15 | 0.15 |
| | Energy tax | –– | 32.0 | –– | 0.19 | –– | 0.02 |
| | Others (revenue from forest) | 31.9 | 28.1 | .20 | 0.17 | 0.03 | 0.02 |
| National taxes | Total national taxes | 14,221.2 | 14,691.3 | 87.21 | 86.39 | 12.47 | 11.35 |
| | Tax amnesties | 164.8 | 29.1 | 1.01 | 0.17 | 0.14 | 0.02 |
| Total national taxes | Total national taxes including amnesties | 14,386.0 | 14.720.4 | 88.21 | 86.56 | 12.61 | 11.36 |
| | Local taxes | 1,002.0 | 1,255.0 | 6.14 | 7.38 | 0.88 | 0.97 |
| Local taxes | Total national & local taxes | 15,388.0 | 15,975.4 | 94.35 | 93.94 | 13.49 | 12.33 |
| | Social security contribution | 921.0 | 1,031.0 | 5.65 | 6.06 | 0.81 | 0.79 |
| TR | TOTAL TAXES | 16,309.0 | 17,006.4 | 100.0 | 100.0 | 14.30 (tax effort) | 13.12 (tax effort) |
| | GNP | 114,072.0 | 129,612 | | | | |
| | | Absolute Value | | | | | |
| | Total taxes/Population (43M) | ₱379.30 | ₱395.50 – per capital revenue | | | | |

* Less than 0.01.

*Note:* Peso-Dollar Exchange Rate: *1975* 1US$ : ₱7.2478; *1976* 1US$ : ₱7.4405
M stands for million

***Source of basic data:***
Tax Statistics Staff, NTRC
For Exchange Rate – CB Foreign Exchange Department

## APPENDIX B

### Statistics on the Investment Incentives Act and the Export Incentives Act

| | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 |
|---|---|---|---|---|---|---|---|---|
| A. RA 5186, as amended (Investment Incentives Act) | | | | | | | | |
| 1. No of registered projects | 8 | 50 | 79 | 97 | 115 | 157 | 203 | 243 |
| 2. Value of actual investment in million pesos | 54.94 | 280.90 | 362.20 | 476.92 | 716.77 | 906.30 | 1,287.48 | 2,268.04 |
| 3. Actual labor | 6,791 | 14,926 | 24,538 | 33,024 | 42,781 | 58,044 | 74,609 | 90,968 |
| B. RA 6135, as amended (Export Incentives Act) | | | | | | | | |
| 4. Export Earning in thousand $ | | | | 56,192 | 61,771 | 133,977 | 87,915 | |
| 5. Share in Total Philippine Exports (%) | | | | 3.75 | 4.63 | 6.60 | 6.33 | |
| 6. Share in non-traditional manufactured exports (%) | | | | 62.22 | 47.63 | 51.29 | 67.00 | |

*Source:* NEDA-BOI Survey based on data submitted by reporting registered firms only.

## LIST OF TAX TREATIES

### Concerning comprehensive double taxation treaties on income/capital

### The list is up to date as of March 31, 1978

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Belgium | income | October 2, 1976 ** | | |
| Canada | income | March 11, 1976 | English and French | AP treaties |
| Denmark | income, capital | December 16, 1966 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 171 |
| France * | income | January 9, 1976 | English and French | AP treaties |
| Singapore | income | August 1, 1977 | English | AP treaties |
| Sweden | income, capital | April 12, 1966 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 161<br>Treaty Series, Vol. 710, p. 72 |
| United Kingdom | income | June 10, 1976 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 368 |
| U.S.A. * | income | October 1, 1976 | English | AP treaties |

* Not yet in force.
** Not yet published.

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation).
SUPP. SER. Section C = Supplementary Service to European Taxation.
Treaty Series = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French as the case may be.
UN = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes.

# WESTERN SAMOA: Tax Structure and Fiscal Policy

by Earl H. Forbes*

## I. CATALOGUE OF TAXES, DUTIES AND FEES

### (a) Customs duties — (import)

Authority — Customs Tariff Act 1975
Maximum rate — 135 percent (e.g. on motor cars of engine capacity over 3000 c.c.)
Minimum rate — 5 percent (e.g. on agricultural imports)
Total collection 1977 — WS$7.49 million
Percentage of total Government Revenue — 39.9 percent

### (b) Customs duties (export)

| | | |
|---|---|---|
| Authority | — | Export Levy Act 1977 |
| Rate | — | 7 percent on excess of WS$800/00 per long ton of cocoa and on excess of WS$100/00 per tonne of copra. |
| | — | The levy was effective from October 1977 and collections for the last quarter of 1977 amounted to WS$155,000. |

### (c) Income tax

| | | |
|---|---|---|
| Authority | — | The Income Tax Act 1974 |
| | — | The Income Tax Administration Act 1974 |
| | — | The Income Tax Rate Act 1974 |
| Rates of tax | — | Companies (resident) — 42 percent |
| | — | Companies (non-resident) — 48 percent |
| | — | Companies (life insurance) — 7½ percent of gross premiums |
| | — | Companies (non-life insurance) — 15 percent of gross premiums |
| | — | Trustees — 50 percent |
| | — | Non-resident shipping and aviation — 5 percent of gross receipts. |
| | — | Non-resident film distribution companies — 15 percent of gross receipts. |
| | — | Withholding income —dividends, interest, royalties and know-how payments derived by a non-resident — 15 percent. |
| | — | Dividends (residents) — 5 percent. |
| | — | Other taxpayers — Liable at rates which start at 5 percent and rise to 50 percent at taxable income over WS$10,000. Non-residents are liable at the same rates as residents but are not entitled to any special exemptions (personal and family allowances and reliefs) |
| Extent of liability | — | Residents are liable to tax on "all income derived from Western Samoa or elsewhere", and non-residents on "all income derived from Western Samoa". |
| Total collection 1977 | — | WS$2.6 million. |

Percentage of total Government revenue — 13.9 percent.

### (d) Foreign exchange levy

| | | |
|---|---|---|
| Authority | — | Foreign Exchange Levy Act 1977 |
| Rate of Tax | — | 1 percent flat rate on the gross value of all sales of foreign exchange by authorised banks. This tax was introduced on 25 August 1977, and it is anticipated that it will bring in approximately 2.5 percent of total government revenues. |

### (e) Estate and gift duties

| | | |
|---|---|---|
| Authority | — | The Estate and Gift Duties Ordinance 1955 (NZ) |
| Maximum rate (Estate duty) | — | 40 percent |
| Minimum rate (Estate duty) | — | 6 percent. Dutiable estates of less than WS$2000 in value are not subject to duty. |
| Maximum rate (Gift duty) | — | 50 percent |
| Minimum rate (Gift duty) | — | 9 percent. Aggregate gifts of less than WS$2000 in value per year are not subject to the duty. |
| Total duties collected in 1977 | — | approx. WS$100,000 or 55 percent of total Government revenues. |

* Acting Commissioner of Inland Revenue.

**(f) Business licence fee**

| | | |
|---|---|---|
| Authority | — | The Business Licence Ordinance 1960. |
| Rate | — | A licence fee of WS$18 per annum is payable for each type of business specified in the schedules to the Ordinance. |
| Extent of liability | — | All persons are liable whether resident, non-resident or temporarily present in Western Samoa for the purpose of carrying on any business or calling. The Ordinance is both a "control" and "revenue" measure. |

**(g) Other than the above Government derives revenues from the following sources**

Sale of liquor — WS$2.00 million or 10.7 percent of total revenue. In Western Samoa the state is the monopoly importer and wholesaler of all alcoholic beverages. (This represents gross sales, and is not a net profit figure).

Post and radio department revenues — WS$0.77 million or 4.4 percent of total revenues.

Sale of numismatic coins — WS$0.88 million or 5.5 percent of total revenues.

Miscellaneous receipts — WS$4.63 million or 22.5 percent of total revenues. Under this heading is included wharfage and port duties, licence and registration fees, income from government property, interest on government investments and foreign assets, and receipts fees and charges from various departments for services rendered.

## II. ORIENTATION OF FISCAL POLICY: TAXES ON INCOME, PROFITS, ESTATES AND GIFTS

### A. Investment — (domestic and foreign)

#### *1. In general*

Broadly, the Government's aim is to speed up the development of the country through the joint efforts of the public and private sectors. As in the case of most developing island nations of this region, this effort must in the initial stages depend upon a flow of capital, and technical and managerial skills from the developed countries of the world (or more especially from her more developed neighbours) to Western Samoa. The public sector has and will continue to depend upon "aid" in various forms from foreign Governments and international organisations. Likewise, the Government recognises that significant development in the private sector would have to depend to a considerable extent on overseas capital, technical and organisational skills, and marketing and distributing "know-how", not only as a once-and-for-all phenomenon, but on a continuing basis. Western Samoa is fortunate in having a stable political system and since independence successive Governments have tried as far as possible to set up the necessary infrastructure, and to create a clear fiscal policy for generating greater domestic and foreign investment.

In 1965 (3 years after the country gained independence) an Enterprises Incentives Act was enacted making available generous customs duty and income tax concessions to "Approved Enterprises." This Act is still in force. The first review of income tax legislation since independence was undertaken in 1973 and 1974. The three Inland Revenue Acts of 1974 (effective from 1 January 1975) sought to consolidate, simplify, and up-date a maze of legislation, and bring it in line with the changing aspirations of the emerging independent nation. Estate and gift duties legislation was also reviewed at the time, but the amended Bill has not been enacted as yet. In keeping with this trend an Industrial Free Trade Zone Act was passed in the same year (1974) and in the next year the Third Five-Year Development Plan (1975 to 1979) re-iterated the Government's intention to generate greater domestic and foreign investment.

#### *2. Implementation of policies and legislation*

The administration of fiscal legislation is largely the work of the Departments of Economic Development, Inland Revenue, Treasury and Customs. Where no income tax or customs duty concessions are sought an investor, local or foreign, should apply to the department of Inland Revenue for a business licence. Licences are issued under the terms of The Business Licence Ordinance 1960 which Act is administered by the Inland Revenue. In considering applications for a licence, the primary considerations are:

- the extent to which the business, or services proposed to be rendered, are necessary or desirable in the public interest;
- the extent to which the economic welfare of those persons engaged in any similar business or calling would be affected by the grant of the licence;
- in the case of foreign investors or professionals, what immediate and future effects the grant of a licence would have on their local counterparts.

There are no express prohibitions on the issue of licences, though in the case of foreign applicants the Government would prefer Samoan participation in share capital control and management.

Where tax and duty concessions are sought preliminary inquiries should be made with the Department of Economic Development which is charged with the administration of The Enterprises Incentives Act, 1965. Six broad types of enterprises may qualify for concessions on "establishment or expansion". They are:

- factory for the processing of primary agricultural or pastoral products;
- factory of any other description;
- hotel and visitor support facilities;
- fisheries and fisheries development;
- afforestation;
- research and research development.

If recommended for approval by the Incentives Board, and subsequently formally approved by the Cabinet, an enterprise may enjoy generous fiscal concessions. These are:

- Complete exemption from income tax for a period ranging from 1 year to 10 years. The duration of the tax holiday is dependent upon the type, size and nature of enterprise.
- Provision for carry forward of "exempt" period losses into the "liable" period.
- Exemption from income tax of dividends received by any shareholder during the tax holiday period, or within two years thereafter, out of profits arising during the tax holiday period. This exemption is limited to the amount of shareholders paid up capital during the tax holiday period.
- Complete or partial exemption from payment of duty on importation of building materials, plant, machinery, vehicles and other apparatus required for "establishment or expansion", and on raw materials imported for use in an approved enterprise.

The Cabinet is inclined to grant concessions available under the Act more readily if the enterprise offers a visible benefit to the country such as a high percentage utilisation of local raw materials, foreign exchange savings and creation of employment opportunities for the Samoan people.

During the past three years the number of initial approvals (besides extensions of existing approvals) was:

| | | |
|---|---|---|
| 1975 | — | 8 enterprises |
| 1976 | — | 7 enterprises |
| 1977 | — | 18 enterprises |

These figures bear testimony of the Government's recent vigorous efforts to enlist private investment in achieving a quicker rate of economic development.

There has been little citicism of the operation of the Incentives Act. Theoretically, the scheme of incentives could be said to be over-simplified in that all enterprises are entitled to claim the same concessions, be they export oriented or catering only for the domestic market, whether the local value-added to the product is high or only minimal.

### 3. *Investment policy – as reflected in the Inland Revenue Acts*

In 1974, the law relating to the imposition of income tax was revised and the new Inland Revenue Acts (1974), displayed a departure in many ways from the pre-independence Ordinance of 1955.

While the anti-avoidance and penal sections of the law were tightened up, there was for the first time generous tax concessions offered to those deriving income from primary production — viz.: the farming of land, the making of Samoan handicrafts, and the catching of fish by residents within the territorial waters of Western Samoa. It is laid down in the statute that the tax exemption shall be for a ten year period — 1/1/75 to 31/12/84. This blanket tax concession had the effect of narrowing the tax base, and making a substantial dent in tax revenue collections. Nevertheless, official thinking was that the advantages outweighed the loss of revenue. Western Samoa is blessed with a hot-wet climate and fertile soil that is excellent for crops such as coconuts, cocoa, coffee, bananas and yams. Conditions are also suitable for animal husbandry — the rearing of cattle, pigs and poultry. The ocean surrounding the island nation is an abundant fishing ground. In spite of this Western Samoa was importing large quantities of fresh and canned fish and meat, and various forms of dairy products. The tax incentives were meant to generate greater investment in the agricultural sector. It is as yet premature to comment, but the incentives do not appear to have brought results. Presently too, cheap canned and frozen fish and meats are imported in increasing quantities. Earnings from copra and cocoa went up in 1977 not due to increased production, but as a result of escalating world market prices for these commodities.

The 1974 tax act also incorporated a change in the rate structure designed to stimulate greater corporate investment. The maximum rate for resident companies was reduced from 50 to 42 percent, and for non-resident companies from 52.5 to 48 percent. The rate for individual taxpayers was however increased from a 40 percent maximum to 50 percent.

Income tax legislation was also framed to attract, capital in a non-commercial sense, into Western Samoa. Although interest paid to a non-resident is liable to a 15 percent withholding tax, interest paid outside Western Samoa on government stock or debentures is tax free. A tax exemption on interest is also available to any financier who concludes an "exemption" agreement or arrangement with the Government.

Other significant benefits under the Acts are provision for the indefinite carry forward of losses as well as provision for the grant of depreciation allowances over and above the schedule rates if the enterprise is set up for the purpose of "encouraging the development of Western Samoa". No maximum rate is stipulated and theoretically any rate may be fixed by the Minister.

In practice this section has not yet been invoked. In 1967 there was a single instance where the Government extended special tax treatment to a foreign company by a separate Act of Parliament. The company was given a tax holiday period, and subsequently was to be liable to tax at a rate of 25 percent only. The company was also entitled to decide at what rates it would depreciate assets, subject to a 100 percent (on cost) limit over five years. This was an isolated instance and it must not be assumed that special treatment is generally available. The present attitude is for foreign investors to make use of the concessions generally available under incentives legislation (supra).

### 4. *Investment policy – as reflected in estate and gift duties legislation*

There has been recent concern in regard to the imposition of these duties. The law still in force is the Estate and Gift Duties Ordinance 1955 (N.Z.) and amendments up to 1962. Exemption limits, rates, and widows' and children's successions have not been revised, and duties are consequently a heavy burden. In fact this law was considered as part of the New Zealand "black budget" legislation in that country, and has since been much revised there. Together with other relevant factors, e.g. rapidly rising property values, present rates of duties are a disincentive to vigorous enterprise and investment.

The Government is aware of these trends, and is committed to revising the law this year. The proposed Act contains many reliefs in comparison with existing legislation. These are:

*Estate duty*
- increase of the lower exemption limit,
- increase of the maximum widows' succession,
- exemption of freehold land up to a specified limit (under existing legislation, there is no exemption in respect of freehold land),
- reduction of the maximum rate by at least 5 percent.

*Gift duty*
- substantial increase of the lower exemption limit.
- reduction of the maximum rate by at least 10 percent.

The proposed amendments are illustrative of the present "easing off" attitude on estate and gift duties, in order, among other things, to stimulate greater investment and savings.

## B. Trade (domestic and foreign)

### 1. *Export trade*

Faced with a recurrent trade deficit, it is the Government's policy to maximise the volume of exports. Imports exceeded exports by:

WS$ 10.43 million in 1973
WS$ 8.23 million in 1974
WS$ 18.61 million in 1975
WS$ 18.18 million in 1976

Measures taken to reduce the imbalance are:
- establishment of a Copra Board, Cocoa Board, and Banana Board to handle these exports exclusively;
- setting up of a scheme for refund of duty on imports if such imports are processed and re-exported;
- abolishing export duties. However, very recently (October 1977), in the context of buoyant world market prices for copra and cocoa, an export duty of 7 percent was introduced for prices in excess of WS$800 per long ton of cocoa and in excess of WS$100 per tonne of copra;
- an incentive allowance (to be allowed as a deduction from assessable income) of 25 percent of the increase in the value of primary production exports over the previous year, or above the "base period" figure. This will become operative once the tax exemption in regard to primary production expires — vide para A,3 supra.

Major export earnings in 1976 were from:
- cocoa 40.76 percent.
- copra 34.40 percent.
- taro and taamu (edible yams) 6.67 percent.
- bananas 2.64 percent.
- coconut cream, clothing, handicrafts, timber and other miscellaneous goods make up the balance of 15 percent.

### 2. *Import trade*

Commerical imports are regulated through a system of foreign exchange allocations. Five items considered as essential — rice, flour, sugar, milk products and canned fish — may be imported outside the allocation system. In any case foreign exchange allocations are not given on a product basis. Instead, all persons in the import business are given a quantitative allocation which could be used for importing goods as consumer demand requires.

The food, beverages and tobacco group accounts for 33.68 percent of imports, machinery for 23.41 percent, manufactured goods for 18.13 percent and fuel and oil for 12.42 percent. The largest exporters to Western Samoa, in order, are New Zealand, Japan, Australia, U.S.A. and the United Kingdom.

Escalating world prices and consumer demand within the country have made it difficult for the Government to contain the rising import bill. The strategy adopted is to:
- promote greater local production of agricultural and farm products and to develop the fishing industry. Income from these sources is fully tax exempt.
- Encourage greater use of local raw materials in domestic industry. Incentive legislation is being currently looked at, inter alia, with this in view.
- Discourage consumption of imported luxury items by levying relatively high import duties, e.g. vehicles (non-commercial) 115 to 135 percent, perfumes 78 percent, and radio sound equipment 70 percent.
- Limit over-all imports by a system of foreign exchange allocations.

While export earnings have shown an upward trend especially in the last quarter of 1976 and in 1977, the effort to limit imports has not proved successful. One drawback in existing fical measures is that local industries are required to compete with foreign manufacturers after expiration of the tax holiday periods. Some businesses have been forced to close down in the face of this open competition. A system of more prolonged protection for local industries will have to be worked out if industrial expansion is to continue and the trade deficit narrowed.

### 3. *Domestic trade*

There is very little data on this. In point of fact, the wholesale trade in imported goods is in the hands of the large merchandising companies in Apia (the capital city). Retail trading is the province of numerous storekeepers scattered throughout the country. A new central market has been constructed to facilitate the sale of vegetables, fruit and fish.

Government policy is to assist trade by providing as many facilities as possible. The State operates an agricultural store in competition with the private sector, and many government corporations (handicrafts for one) operate on the same basis. The Government exercises a monopoly only in the importation of alcoholic beverages.

### C. Transfer of technology, know-how and managerial skills

At present, there is a shortage of technical and managerial skills among the local residents. As a consequence, Government or State Corporations and the larger private sector enterprises employ quite a number of expatriates on contract. These personnel are there in addition to those from international organisations, and aid donor Governments. There is no work permit system in operation. Non-citizens employed under an approved contract are issued with residence visas, which are valid until the termination of the contract. The Government has not been reluctant to grant visas to acceptable applicants and members of their families. Exemption from income tax is available to non-residents if;

- the services rendered by the non-resident are primarily and principally directed to assisting the Government in the settlement or development of Western Samoa; or
- the services are performed for or on behalf of a non-resident pursuant to any arrangement for assistance entered into by the Government of any other country or with any international organisation.

In the movement towards industrialisation and industrial expansion Western Samoa, like most developing countries, leans heavily on foreign technology. There is no favoured tax treatment of particular types of royalty or know-how payments. Such payments are taxed at the rate of 15 percent on gross receipts.

### D. Diversification and selectivity

Policy is flexible and investment is solicited from any country. In fact however, investment has come from areas with which Samoa has had a historical connection, i.e. New Zealand, and from countries with which there have been links viz. Australia, Japan, the U.S.A. and Germany (The Federal Republic). Some countries such as New Zealand have their own schemes for encouraging investment in the Pacific Islands e.g. The Pacific Islands Industrial Development Scheme.

Fields in which the Government would welcome local or foreign investment are:

- production of coconut oil for export and meal for local consumption;
- manufacture of wooden building materials;
- manufacture of veneer, plywood, particleboard and hardboard;
- manufacture of cocoa, chocolate powder from beans and chocolates for export;
- boat building;
- canning or quick freezing of fish and shrimp;
- canning or quick freezing of fruits and fruit juices;
- grinding, roasting and packaging of spices;
- fertilizer mixing plant;
- coconut charcoal production;
- tannery and leather manufacture;
- tourist promotion and development.

Overseas investment most favoured is that which is employment generating, makes the greatest use of indigenous raw materials, contributes to export incomes, strengthens capital goods production, and brings in technical knowledge and skills.

As Western Samoa has a relatively small land area (1097 square miles) there are no particular regions to which investment is to be directed. Due to the availability of supportive facilities and conveniences most industries have been set up within a 5 to 7 mile radius of the capital city, Apia. The proposed industrial free trade zone too is to be set up within this radius.

### E. Differences in treatment — public and private sectors

Concessions to public sector enterprises take various forms.

- The State exercises a monopoly right over the importation of all alcoholic beverages, the operation of telephone services, and the supply of electric power. The Electric Power Corporation enjoys duty free concessions and is fully income tax exempt.
- In the field of insurance the Government operates two corporations which are liable to tax. However, the corporations enjoy a benefit because non-resident insurance companies seeking to operate in Western Samoa are required to deposit with the Government a fairly substantial sum prior to the commencement of operations.
- Certain other undertakings, such as the Handicrafts Corporation, operate with no special fiscal benefits.

While it has not always been observed, the general principle is that "utility service" corporations must enjoy duty free and/or tax free concessions while "trading" public sector ventures must compete on an equal footing with the private sector.

## III. ORIENTATION OF FISCAL POLICY — SALES TAXES, EXCISE DUTIES AND CUSTOMS

(A) Western Samoa imposes no sales taxes or excise duties at present. However, this situation is not likely to continue very long. The Cabinet has recently approved the introduction of a Business Turnover Tax in mid 1978, or in early 1979. Excise duties are also likely to be imposed in 1979 when the Western Samoan Brewery (now under construction) and a non-resident cigarette manufacturing company commence commercial production. The proposed Turnover Tax and excise duties will be first and foremost revenue measures. Turnover tax is likely to be at a flat rate of 1½ or 2 percent and will not be used initially as a tool for achieving other economic or social objectives.

### (B) Re-distribution of wealth

Western Samoa is an area with many traditions which have various consequences. Approximately 80 percent of all land is "customary land". These lands are administered in accordance with the traditional practice of the Samoan people. No individual owns any specific part of customary land. Control is vested in the Aiga (extended family group) within which the Matais (chiefs) are the effective leaders. Fiscal measures which in a general sense achieve a diffusion of wealth are the progressive rate of income taxation, high rates of gift and estate duties, and penal customs duties on certain items. Successive Governments have not sought to deal with this problem other than indirectly through the measures quoted above.

### (C) Employment

This matter has caused serious concern during the past 2 to 3 years. Up to 1974 net emigration from Western Samoa was substantial. Emigrants exceeded immigrants by:

— 1144 persons in 1972
3778 persons in 1973
4244 persons in 1974

A large percentage of young Samoans were attracted to New Zealand by wages which were 5 to 6 times higher than that paid locally. Due to the social system, a good portion of the earnings abroad were remitted to the "Aiga" (family) in Samoa. There was, thus, a dual benefit to the country.

In 1975 a change in the rules governing entry into New Zealand greatly reduced the number of Pacific island migrants to that country. This has thrown an additional 4,000 young persons per annum on the job market. The figures are snowballing each year and numerous schemes are being implemented to provide more employment. In this context existing incentives legislation is being implemented with a bias towards job-creating industries. The Cabinet is prone to grant incentives more readily to prospective industries which will provide the most number of jobs. There is nothing in existing legislation which favours job-creating industries over others. However, in an on-going review of incentive legislation, the question of granting additional benefits to industries which employ more than a certain number of persons is being considered.

### (D) Regional development

The territory of Western Samoa is comprised of two main islands — Upolu 430 sq. miles, and Savaii 600 sq. miles. Thirteen miles of sea separate the two islands at the closest point. The smaller island of Upolu is more populated and developed than Savaii. Most industries are situated in close proximity to the port of Apia in Upolu. The question of regional development is not of significance in view of the small land area. There is a relatively high proportion of industrial sites in proximity to the capital city itself. The only matter of significance in this regard is the recent effort to exploit the timber resources and the agricultural potential of the less developed larger island of Savaii. The Government has made liberal income tax and customs duty concessions to a foreign company established for exploiting timber resources in Savaii. This is an isolated case of special treatment. At present, there are no separate fiscal measures favouring the development of the larger island.

## IV. ORIENTATION OF FISCAL POLICY — NON TAX FIELDS

### (A) Subsidies

These are provided only in a limited manner and this trend is likely to continue in the predictable future. Agriculture and agricultural exports draw off 80 percent of subsidies. There are subsidies on:

- planting of coconut palms;
- planting of cacao trees;
- export of bananas;
- and, on agricultural inputs such as fertilizer (80 percent subsidy), pesticides, weed-killer and similar items.

### (B) Low interest loans

There is no special machinery for obtaining low interest finance. The three major lending institutions charge interest on local borrowings at the following rates:

- Bank of Western Samoa — 9 to 11 percent.
- Development Bank — agricultural loans 8 to 10 percent.
  — industrial loans 10 to 12 percent.
- National Provident Fund — 8 to 10 percent.

Interest paid to non-resident financiers is presently liable to a 15 percent withholding tax which is also the final tax. There is a move at present to further exempt interest paid to non-residents i.e. if the finance is for "national development". This, if approved, will operate alongside the exemption referred to in paragraph A,3 above.

### (C) Infrastructure

The Government has a standing policy to improve facilities. Emphasis is placed on continual upgrading of the water supply, roads and health services. The manual telephone system was replaced with a fully automatic exchange in October 1977. Also Samoa Shipping Services (with a 50 percent government shareholding) was established very recently with a view to improving shipping to and from Samoa. There are current proposals for upgrading wharf facilities and for enlarging the airport to accommodate bigger planes. The Third Five-Year Plan *(1975-1979)*, places great importance on improvement of the infrastructure. A broad range of projects have been proposed for implementation during the 5 year period. The proposed investment requires a substantial share (in the order of 43 to 45 percent) of total planned development expenditure.

### (D) Industrial estates and/or free trade zone

In 1974 a Free Trade Zone Act was passed as a first step in establishing such a zone in Western Samoa. The Act grants:

- exemption from customs duties;
- exemption from income taxes for 5 years; tax payable at 25 percent thereafter;
- provision for carry forward of losses incurred during the tax free period into the chargeable period;
- provision for repatriation of capital and of all dividends, profits and income.

In spite of the generous benefits offered, there was very little response from outside to set up industries under the terms of the F.T.Z. Act. The scheme has not as yet got off the ground. Some of the reasons for this are touched upon in the succeeding paragraphs.

Most of the benefits offered under the F.T.Z. Act are available under the "Incentives Act 1965", and many of the new enterprises have taken advantage of the concessions under the latter legislation. Although not visualised under any enactment, an industrial estate is in fact developing at a site approximately 4 miles from the capital city, Apia. The Government is supporting this development by locating state-sponsored industries in this area. Also every effort is being made to provide an infrastructure at the site to meet the needs of the most demanding industries.

## V. BRIEF EVALUATION

National development, even for a small country such as Western Samoa, is a long drawn out process. During the past 15 years the process of advancement has gone on, but still there is much to be achieved. Fiscal policies as a part of development strategy have proved to be a success in some areas. There are no accurate figures of domestic trade, but judging by the annual increase of business licences issued, and by the tangible increase of trades and businesses, there is reason to conclude that development goals are being met. Likewise foreign investment from 1969/70 to the present time has increased at an approx. average of 40 percent per annum. Government revenues from customs duties and income taxes have increased 125 percent over the past 5 year period. In tangible terms, progress is visible in better roads and telephone services, new housing, new vehicles and the like, and in new factories, stores, showrooms and offices. Many Samoans now enjoy a level of living far above that of a decade ago.

Though progress is evident, there are many spheres in which the strategy of development has not proved to be successful. Export data suggests that agricultural production has been static and in regard to some crops exports declined in recent years. Western Samoa is primarily an agricultural country and this trend does not augur well for its future. Also in spite of all efforts to contain the "import bill" it has continued to increase sharply. Total imports from 1973 to 1975 rose as follows:

- 1973 WS$ 13,044,300
- 1974 WS$ 15,909,100
- 1975 WS$ 23,160,000

The terms of trade are against Samoa and this is likely to remain so for the next 3 to 4 years at least.

The effort to set up a free trade zone in the country has not become a reality although legislation was passed in 1974. Like many Pacific islands, Western Samoa is isolated, and rising transportation costs have deterred investors from coming so far afield. Markets in Samoa and in the vicinity of the islands are also very limited. In comparison, some South-East Asian and Far Eastern countries have established free trade zones with easy access to the markets of Asia, the Middle East and Africa. Samoa's efforts to stimulate investment, increase employment opportunities, and attract technology and skills via a free trade zone, have been thwarted due to international developments beyond its control.

It is neither possible nor necessary to enumerate here every area of success or setback. An appropriate judgement overall would be to say that the implementation of policies so far has brought qualified results.

# AUSTRAL A~ a selected bibliography

## BOOKS

### AUSTRALIAN GIFT AND ESTATE DUTIES OF THE COMMONWEALTH AND ALL AUSTRALIAN STATES

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### STAMP AND ESTATE DUTIES — NEW SOUTH WALES

Being the 4th ed. of Lee's "Law and Practice of Stamp, Death and Estate Duties". By A.F. Tolhurst. Chatswood, Butterworths, 1971. 691 pp.

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Compilation of the text of relevant case law on corporations and associations. A chapter on taxation of corporations, partnerships and associations is appended. The cases present the state of the law as of October 1971. (B. 7419)

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Sydney, Bank of New South Wales, 1974. 82 pp.

Twelfth edition of a booklet providing information on business opportunities in Australia. An "Amendments to the Twelfth Edition", published November 1974 provides corrigenda to the text due to several changes since publication. Taxation is considered. (B. 9906)

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### THE ASPREY REPORT

An analysis. Nothryde, CCH Australia, Ltd., 1975. 175 pp.

Summary of the full Asprey Committee Report which examines and formulates proposals for improving the taxation system. (B. 9378)

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By P.J. Cowdroy. Sydney, CCH Australia, Ltd., 1975. 28 pp.

Monograph dealing with the Asprey Taxation Review Committee's recommendations on the taxation of companies for purposes of Australian tax law. (B. 9655)

### INCOME TAX FOR PRIMARY PRODUCERS

Ninth edition. Prepared by the Australian Taxation Office, and issued under the authority of the Treasurer, the Hon. J.F. Cairns, M.P. and the Minister for Agriculture, Senator the Hon. K.S. Wriedt. Canberra, Australian Government Publishing Service, 1975. 71 pp. (B. 9189)

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Report of Committee of Inquiry into Inflation and Taxation. Canberra, Government Printer, May 1975. 747 pp.

This so-called Mathews Report inquires into the effects of inflation on taxation paid by persons and business enterprises. (B. 9395)

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An analysis with extracts. Northryde, CCH Australia, Ltd., 1975.102 pp.

This book contains an analysis of the Mathews Report as it affects the taxation of companies and other enterprises. Selected extracts from the Report itself have been included. The Mathews Report of the Committee of Inquiry into Inflation and Taxation was tabled in Parliament on May 26, 1975. (B. 9379)

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By J.A. Irwin and H.B. Lamble. Sydney, CCH Australia, Ltd., 1975. 44 pp.

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INCOME TAX FOR THE MINING INDUSTRY

Canberra, Australian Government Publishing Service, 1976. 21 pp.

This booklet sets out the main features of the Australian income tax law as it applies to prospecting and mining enterprises as of May 1976. Sales tax and payroll tax are included. (B. 9797)

1977 AUSTRALIAN MASTER TAX GUIDE

Northryde, CCH Australia, Ltd., 1977. 568 pp.

Guide designed to help taxpayers in preparing their income tax returns for the 1977 income tax year. (B. 50.781)

TAXPAYER

1977 Annual taxation summary. Melbourne, Australian Taxpayers' Associations, 1977. 178 pp.

A comprehensive survey of the major points of the various taxes imposed by the Commonwealth of Australia and the States.

AUSTRALIAN INCOME TAX GUIDE

23rd Edition. By E.F. Mannix and D.W. Harris. Sydney, Butterworths, 1978. 812 pp.

Guide explaining the Australian income tax law as of December 31, 1977. More detailed comment is contained in Australian Income Tax Law and Practice. (B. 101.089)

# LOOSE~LEAF SERVICES

AUSTRALIAN INCOME TAX; LAW AND PRACTICE

11th edition. By E.F. Mannix and D.W. Harris.
— Replacement pages;
— Bulletin;
— Cases.
Sydney, Butterworths, 1975.
Supplemented: fortnightly.

Loose-leaf publication consisting of 11 volumes. The full text of the Income Assessment Act is set out section-by-section, and each section is followed by annotations prepared by the editors. The annotations consist of an analysis of the section, notes on all the decided cases which have a bearing on the section, examples and relevant departmental announcements. The Income Tax Regulations and related legislation including double taxation treaties are appended. The material in this work is updated by a special loose-leaf service: Replacement Pages. In addition, the publisher supplies supplementary services for information on tax developments and on case law in Bulletin and Cases, respectively, to be filed in loose-leaf binders entitled Australian Income Tax-Law and Practice-Bulletin, Australian Income Tax-Law and Practice-ATR, and Australian Income Tax-Law and Practice-CTBR (N.S.)
(ATR and CTBR are also published annually in bound volumes, respectively entitled "Australasia Tax Reports" and "Commonwealth Taxation Board of Review Decisions").

SALES TAX; EXEMPTIONS AND CLASSIFICATIONS

Canberra, Commonwealth Taxation Office, 1971.
Supplemented: periodically.

Details of current official rulings on the classification of goods under items in the Schedule to the Sales Tax (Exemptions and Classifications) Act. The material will be kept up to date by the issue of replacement pages. A comprehensive index is appended.

# PERIODICALS

**Regularly received by the library**

THE AUSTRALIAN ACCOUNTANT — monthly — Accountants Publishing Co., Ltd., 49 Exhibition Street, Melbourne, VIC 3000, Australia.

THE TAXPAYER — fortnightly — Australian Taxpayers' Associations, Suite 5A, 343 Little Collins Street, Melbourne 3000, Australia.

TAXATION IN AUSTRALIA — monthly — The Taxation Institute of Australia, 19th Floor, C.A.G.A. Building, 8 Bent Street, Sydney, N.S.W. 2000, Australia.

WEEKLY CURRENT TAXATION — weekly — Butterworths, Pty. Limited, Sydney 586 Pacific Hwy, Chatswood. NSW 2067, P.O. Box 454, Australia.

WEEKLY CURRENT TAXATION — weekly — Butterworths, Pty. Limited, Sydney, 586 Pacific Hwy, Chatswoods, NSW 2067, P.O. Box 454, Australia.

# Highlights of the activities of Associação Brasileira de Direito Financeiro (filiada à IFA), the Brazilian branch of the IFA during the calendar year of 1977

*Meetings held*

— Meeting held on March 29, at luncheon time, attended by many members of ABDF; a conference was made by Dr. Carlos da Rocha Guimarães, on the subject "Legal aspects of the increase of the basis of assessment in the tax assessment". As usual, after the conference those present placed questions to the speaker and a scientifical debate on some of the points raised took place.

— Meeting held on May 3, at luncheon time, with the presence of members of ABDF; Dr. Condorcet Rezende addressed the assembly on the theme "Changes in the income taxation norms to adapt the taxation of legal entities to the new Company Act". Lively discussions on the subject followed Dr. Rezende's address and it was decided that ABDF should prepare suggestions on the adaptation of the tax system of legal entities and submit same to the Minister of Finance, which was done.

— Meeting on June 3, at luncheon time. Dr. Raphael Bernardo d'Almeida Jr. Analysed some basic problems of accountancy arising from the new Company Act, extensive discussions followed.

— Meeting on July 27, at luncheon time. Dr. J.G. Piquet Carneiro submitted his report on suggestions he received from various members of ABDF to the project of a bill to institute the Tax Administrative Courts which was divulgated by the Federal Government. Dr. Piquet Carneiro analysed the suggestions received and it was decided that a subsequent meeting be held on August 3, to approve the official suggestions of ABDF. The meeting was actually held on August 3, as scheduled and subsequent to it ABDF submitted its coments and suggestions to the Minister of Finance.

— Meeting on September 30, at luncheon time. Prof. Pedro Luciano Marrey Junior delivered a conference on tax aspects of the Federal Government Dwelling Program, with peculiar emphasis on the speculation on real estate transactions as an adverse factor in the implementation of the program. Most of the members of ABDF expressed their views on the subject.

— Meetings on November 16 and 23, at luncheon time. The Minister of Finance requested that ABDF (inter alia) submitted suggestions to improve a draft new regulation on the taxation of legal entities, after the norms of the new Company Act. Dr. Condorcet Rezende acting as reporter, the membership attended the two abovesaid meetings in which course there were discussions and decisions on the complete text of the proposed bill, with the result that ABDF offered to the Minister a thorough cooperation as requested.

— Meeting held on December 16, at luncheon time. Dr. Sergio H. Coelho analysed various tax aspects and problems of accountancy related with the reorganization of companies under the new Corporate Act.

*Cooperation with other scientifical institutions*

— ABDF was represented by a large delegation of its members to the ILADT's meeting held at Lima on October 24 through 28, 1977 (VIII Jornadas promoted by the Latin American Institute of Tax Law), and submitted reports on the two themes discussed.

— ABDF was represented by a reasonably significant number of delegates at the XXXI International Fiscal Association Congress held in Vienna, on October 3 through 8. There had been reports by Brazilian members on the two themes discussed.

*Professor Fabio Fannuchi passed away*

To the great regret of all his numerous friends, Professor Fabio Fannuchi passed away on March 13, at the age of 46. Professor Fannuchi was very much reputed for his scientifical work and dedication to academic activities. His books are read with great interest not only by law students but also by tax law specialists.

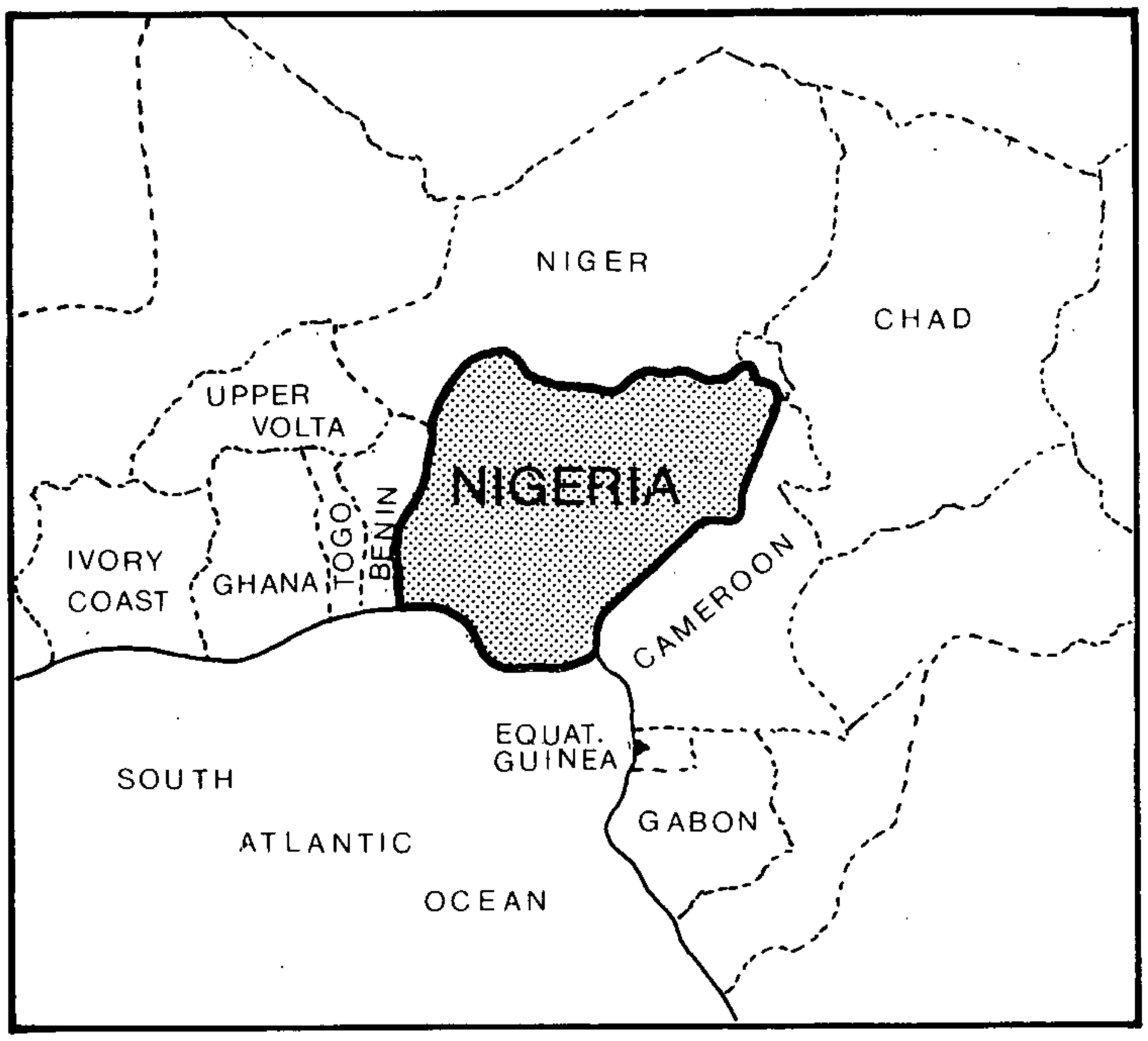
# Personal Income-based Taxation in the Northern States of Nigeria and the Effect of Uniform Income Taxation

by Lawrence A. Rupley*

The focus of the paper is on the period following the creation of twelve states in Nigeria in 1967. Although income taxation is sometimes thought to be an appropriate source of government revenue only in more developed economies, the progressive-rate personal income tax, the personal (or community) tax, and the cattle tax have provided significant amounts of revenue for state and local governments in Benue-Plateau, Kano, Kwara, North Central, North Eastern, and North Western states. The personal tax sometimes provided three times as much revenue as did the progressive-rate personal income tax, and the equity and economic effects of such taxation have generally been acceptable. When uniform progressive-rate income taxation throughout Nigeria was introduced in 1974, the effect was to reduce state government revenue from this source, and to reduce the income tax liabilities of many — but not all — taxpayers in the six states discussed herein. On balance, nationwide uniformity in such taxation is desirable, although the need for revenue by state governments may dictate an increase in the average rates of such taxation. The personal tax and progressive-rate personal income tax ought not to be overlooked for increased use in the future.

Personal income taxation is often assumed to be an inappropriate source of revenue in less developed countries for several reasons: it is administratively complex, the extent of wage employment and systems of tax withholding from wages and salaries is limited, the written records maintained by many small business firms are informal or nonexistent, the level of voluntary taxpayer compliance with tax laws is relatively low, and personal income taxation has historically been relatively unimportant in such countries.[1] However, some income-based taxes have been of considerable significance in northern Nigeria. This article discusses the importance of such taxation as a source of government revenue in Benue-Plateau, Kano, Kwara, North Central, North Eastern, and North Western states after the creation of the twelve-state federation in 1967. It also discusses some of the implications for government revenue and for income taxpayers that resulted from the introduction of a uniform system of progressive-rate personal income taxation throughout Nigeria in 1974. In this discussion, "income-based taxation" includes the progressive-rate personal income tax, the personal tax, and the cattle tax (*jangali*).

The progressive-rate personal income tax attempts to secure information on the taxpayer's actual income, allows for certain deductions or reliefs, generally applies higher rates of tax than does the personal or cattle tax, and those rates of tax increase as taxable income rises. The personal tax is a flat- or low-rate tax often levied on the presumptive income of an individual or group of people. Administrative simplicity is its major characteristic, since no deductions or exemptions from income are allowed, virtually all individuals (or adult males) are taxed, and collection is undertaken once per year. The cattle tax (jangali), as used in the northern states, is




* Dr. Rupley is Assistant Professor of Economics at Emory University, Atlanta, Georgia, U.S.A. Some portions of this article were included in a paper presented at the meeting of the African Studies Association, Houston, Texas, November 3, 1977.

1. For a brief but careful discussion of the conditions encountered and their implications, see A.R. Prest, *Public Finance in Underdeveloped Countries* (2nd ed.), London: Weidenfeld and Nicolson, 1972, Chapter 2.

levied annually, is primarily a means to tax the nomadic herdsmen who are not normally covered by any of the variants of the personal tax, and is intended to be a tax on presumptive income as indicated by the number of cattle owned. [2]

One reason for the impression that personal income-based taxation is a relatively unimportant revenue component in Nigeria arises from the manner in which government budgets and statistical information are published. It is relatively easy to secure revenue and expenditure data for the Federal government, since such data are published in one budget document. However, the greater the number of states, the more difficult it becomes to secure state budget data since each state publishes its budget *Estimates* separately. The problem was relatively manageable when there were only four regional governments, but it has become much more difficult with the creation of twelve state governments in 1967 (and then nineteen in 1976).

This problem is magnified still further in the case of local governments, inasmuch as such budget data is not even easily accessible in consolidated form at state government level. In the northern states of Nigeria, the personal tax and cattle tax revenue is divided between the local and state governments, and represents a significant portion of the revenue of many local governments as well as several states. [3] The portion of such revenue expected by the state government is presented in the state *Estimates.* However, no information regarding the amount to be received by the local governments within the state is presented in any of the state budget *Estimates.* Such information is published by the Ministry of Local Government rather than Finance, and is generally much less widely circulated and accessible. Even though the Federal *Annual Abstract of Statistics* presents some combined Federal, state and local government revenue figures, they are not disaggregated by state. The consequence is that many discussions of public finance in Nigeria simply ignore the local government level. [4]

Personal income-based taxation existed prior to the creation of twelve states in 1967. The Income Tax Management Act of 1961 [5] provided Federal legislation under which the regional governments could levy income taxation. The subsequent legislation in Northern Nigeria — the Personal Tax Law of 1962 — contained provision for a progressive-rate personal income tax, personal (community) tax, and cattle tax. [6] The first complete fiscal year [7] following the creation of twelve states in 1967 [8] was that for 1968—69.

## THE PROGRESSIVE-RATE PERSONAL INCOME TAX

Since April 1, 1974, the rates of the progressive personal income tax and the tax reliefs allowed have been identical throughout Nigeria. [9] As one can surmise, prior to the introduction of uniformity there was a significant degree of variation between the personal income tax systems of the states throughout Nigeria. However, in the case of Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states the variation was relatively small; those states continued to use the system that they inherited in 1967 from the former Northern region with only minor changes. The uniform system introduced in 1974 represents a significant departure from the prior practice of federalism in Nigeria. Although the revenue from personal income taxation continues to belong to the state governments, those governments do not now have the power to alter the structure of tax rates or deductions allowed as they had previously. [10]

## THE PERSONAL TAX

In Nigeria the personal tax is variously known as an income rate, general capitation tax, development rate, development contribution, flat rate, and throughout all the northern states, community tax.

As in a number of Commonwealth African countries, many low-income individuals pay a low-rate personal tax which is assessed on actual or presumptive income. This is basically a poll tax that has been modified by the

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2. Northern Nigeria, Personal Tax Law of 1962 (Law No. 6 of 1962), Kaduna: Government Printer, 1962.
As evidence that the cattle tax was regarded to be a type of income tax in Nigeria's northern states, the law provides that poverty — the *lack* of income — may be grounds for non-payment of the tax.
3. Between 1968 and 1976, the proportion going to the local government varied between 80 and 87,5 percent of the total collected. *Northern States of Nigeria Local Government Yearbook,* Zaria: Ahmadu Bello University Institute of Administration, various years.
4. For example, International Monetary Fund, *Surveys of African Economies,* Vol. 6, Washington D.C.: I.M.F., 1975.
A World Bank Mission to Nigeria in 1971 presents detailed local government revenue figures for 1962-63 and 1963-64 as the most recent available. World Bank, *Nigeria: Options for Long-Term Development,* Baltimore, Md: Johns Hopkins Press, 1974, p. 159.
5. Nigeria, *Annual Volume of the Laws of the Federation of Nigeria,* Lagos: Government Printer, n.d., (Law No. 21 of 1961), pp. A105-A155.
6. Northern Nigeria, Personal Tax Law of 1962.
7. The fiscal year for all Nigerian governments runs from April 1 to the following March 31 during the period discussed herein.
8. In early 1976 the number of states in Nigeria was increased to nineteen.
9. Nigeria, Income Tax Management (Uniform Taxation Provisions, Etc.) Decree 1975 (Decree No. 7 of 1975), *Official Gazette,* Vol. 62, No. 9, 24 February 1975.
As is apparent from the dates, the Decree was published nearly a year after its effective date. See Appendix Table A-1 for the rate schedule.
10. As of April 1, 1977, the rates of tax on incomes above 10,000 Naira were increased, car basic allowance in excess of 600 Naira per year was made taxable, and individuals in the building or construction industry are to be taxed the higher of the tax liability calculated in the normal way or 2.5 percent of gross sales. Also, individuals for whom 10 percent of earned income exceeds 600 Naira can now deduct that higher amount as a personal allowance, and a remarried widow is now eligible for deductions for her children in the same way that her deceased husband was.
Nigeria, Finance (Miscellaneous Taxation Provisions) (No. 2) Decree 1977, (Decree No. 61 of 1977), *Official Gazette,* Vol. 64, No. 43, 1 September 1977.

inclusion of 3 or 4 levels of tax liability to correspond to 3 or 4 different income ranges. [11] In practice, most taxpayers pay the lowest amount that is provided for in the rate schedule. This tax, in the northern states of Nigeria prior to April 1, 1974, convered persons who were not employed where their wages were subject to a Pay As You Earn (P.A.Y.E.) personal income tax withholding system and those who were self-employed, both rural and urban. In Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states the community tax was levied by the state government, it was largely collected by *local* government tax collectors, and the revenue was shared between the state and local governments. The community tax is well suited for use in a rural or small village setting where all residents are well-known to each other and to the elder(s) who are to apportion and collect the tax from the members of the community, and where a strongly authoritarian tradition enforces tax compliance. It has, however, also been used in Nigeria with considerable success in some large urban areas (e.g., Lagos) and in places where traditional local government authority is less strong (e.g., Benue-Plateau state).

As of April 1, 1974, the same Federal Decree that established uniform income taxation provided that a personal tax (called an income rate) should be paid even by individuals who paid the progressive-rate personal income tax. Individuals with total income not exceeding 1,000 Naira were to pay 4 Naira; 8 Naira was to be paid on incomes between 1,000 and 2,000 Naira, and 20 Naira on all incomes in excess of 2,000 Naira. However, that Federal Decree also provided that any existing capitation, community development, education, poll or other general tax or levy imposed on income could be retained or varied instead of the Federally-imposed personal tax. As of April 1, 1977, the personal tax (now referred to as a community rate in the Decree) was changed to a flat amount of 5 Naira payable by each individual who was not subject to the progressive-rate personal income tax. [12]

## THE CATTLE TAX

The cattle tax (jangali) used in the northern states was levied as a flat amount per head of cattle, and taxed the nomadic Fulani herdsmen who were not normally covered by the community tax. [13] It was clearly intended to be a tax on presumptive income: the larger the number of cattle owned, the larger was the potential income from the sale of milk, cheese, and meat. The cattle tax forced the herdsman to realize some of that income in cash in order to pay his tax liability. After 1967 in Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states the prior practice was continued whereby this tax was levied by the state government and largely collected by the local governments. The local governments then retained 80 to 87.5 percent of the revenue. In April, 1975, the *jangali* was abolished by the Federal government in order to encourage meat production *within Nigeria*, and as a means to provide tax relief to the nomadic herdsmen. [14] The removal of the cattle tax contributed to a narrowing of the range of revenue sources available to state and local governments. [15]

## THE IMPORTANCE OF PERSONAL INCOME-BASED TAX REVENUE

If one focuses only on the progressive-rate personal income tax which is wholly a state government revenue source, then it does appear that such revenue is relatively unimportant in the *state* government budgets of Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states. Revenue figures for 1972—73 are used as an illustration in Table 1 because a complete set of data is available for that year. Line 6 of Table 1 shows that revenue from the progressive-rate income tax amounted to slightly less than 6 percent of total *state* government recurrent revenue for the six states as a group, and ranged from a low of 2 percent in North Western state to a high of slightly more than 12 percent in North Central. [16] However, when the revenue from community tax and cattle tax is added to that

11. It is sometimes argued that the personal tax does not properly belong in a discussion of income taxation. If one keeps in mind the fact that this tax is often levied on presumptive income — with visible assets or indicators such as the number of productive trees or the size of one's house or farm or one's occupation often treated as proxies for that presumed income — it seems to this writer that such taxation clearly belongs in such a discussion. In Nigeria, the 1961 Federal Income Tax Management Act states clearly that community tax is to be charged on income — either of the entire community or of parts of it.
See John F. Due, *Taxation and Economic Development in Tropical Africa*, Cambridge, Mass.: The M.I.T. Press, 1963, Chapter 5.
12. Nigeria, Finance (Miscellaneous Taxation Provisions)(No.2) Decree 1977 (Decree No. 61 of 1977), *Official Gazette*, Vol. 64, No. 43, 1 September 1977.
13. This discussion includes only the cattle tax (*jangali*) which is levied on the presumptive income arising from the ownership of cattle. No discussion is included of any taxes or licenses on trade cattle or slaughter stock enroute to or at the point of sale for slaughter nor any veterinary fees for innoculation or inspection; a number of Nigerian states do impose various such licenses or fees.
14. 1975-76 Budget Speech by the Head of State, March 31, 1975. This repeal appears to have been partially based in a concern with tax equity. The buoyancy of petroleum revenues after 1970 permitted the abolition of export duties on produce in 1973 and 1974, the removal of many excise duties in 1974 and 1975, and the reduction of personal income tax rates in 1974; most of these measures, however, provided only minimal tax relief to the nomadic herdsmen.
15. In light of the abolition of the cattle tax and the erosion of or income inelasticity of numerous other local government revenue sources, the Federal government announced that as of April 1, 1977, local governments are to receive 5 percent of Federal retained revenue (and 10 percent of total state revenue) as grants. 1977-78 Budget Speech by the Head of State, March 31, 1977.
16. For the other states in Nigeria for those two years, the concentration of wage employment in Lagos state is very vivid, with 37 percent of revenue in 1970—71 and nearly 46 percent in 1972—73 arising from the income tax. However, in no other state does such revenue exceed 12 percent of the budget — excluding Rivers State in 1970—71 in which revenue collection activity was not yet fully functioning following the Civil War.

from the progressive-rate tax for *both state* and the more than 80 *local governments*, then the relative importance increases substantially. That information is also shown in Table 1. As can be seen in Line 8 of Table 1, the total of all income-based taxes amounts to 15 percent of total state and local recurrent revenue in Kwara state, and between 19 percent and 27 percent in the other five states. Such taxes thus comprise between one-fifth and one-quarter of the state and local government budgets in these states as a group, a contribution of considerably more importance than the impression given by Line 6 of Table 1.

## TABLE 1

**State and local Government revenue from taxes on the incomes of individuals, Benue-Plateau, Kano, Kwara, North Central, North Eastern, North Western States**

(1972–73) (₦ million)

| | Benue-Plateau | Kano | Kwara | North Central | North Eastern | North Western | Total, Six States |
|---|---|---|---|---|---|---|---|
| 1. Progressive-rate Personal Income Tax Revenue – State governments | 1.500 | 2.487 | .900 | 3.256 | 1.070 | .582 | 9.795 |
| 2. Community Tax Revenue – State and Local Governments | 4.612 | 4.569 | 2.268 | 5.239 | 7.919 | 7.014 | 31.621 |
| 3. Cattle Tax Revenue – State and Local Governments | .334 | .345 | .080 | .459 | 2.256 | .728 | 4.202 |
| 4. Total Income-Based Tax Revenue – State and Local Governments (Lines 1 + 2 + 3) | 6.446 | 7.401 | 3.248 | 8.954 | 11.245 | 8.324 | 45.618 |
| 5. Total Recurrent Revenue – State Governments | 24.486 | 33.512 | 18.692 | 26.808 | 35.899 | 29.362 | 168.759 |
| 6. Percent – State Governments (Line 1 ÷ 5) | 6.1 | 7.4 | 4.8 | 12.2 | 3.0 | 2.0 | 5.8 |
| 7. Total Recurrent Revenue – State and Local Governments | 29.932 | 38.780 | 21.836 | 33.154 | 45.750 | 36.574 | 206.026 |
| 8. Percent – State and Local Governments (Line 4 ÷ 7) | 21.5 | 19.1 | 14.9 | 27.0 | 24.6 | 22.8 | 22.1 |

*Source:* Appendix Table A-3.

The diversity in revenue pattern between the six states is sizeable, partially reflecting varied economic and demographic characteristics in the different states. As Table 1 shows, in all these states the community tax was the major contributor to income-based tax revenue. Kwara state had neither a large sector of wage employment nor a large number of cattle, which gave rise to the relatively small importance of personal income-based taxation there. The cattle tax also provided fairly small amounts of revenue in Benue-Plateau and Kano states. North Central state's relatively large wage-employment sector gave it the largest proportion and absolute amount of progressive-rate income tax revenue of these states, followed by Kano. North Western and North Eastern states received the largest amounts of community tax revenue, and the governments in all states received substantially more revenue via the community tax than the progressive-rate income tax. Governments in both North Eastern and North Western states derived more revenue from the cattle tax than from the progressive-rate income tax — more than twice as much in the case of North Eastern.[17] In all cases the omission of community and cattle tax revenue leads to an understatement by at least one-half of the relative importance of personal income-based tax revenue in the state and local government budgets in Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states. (Lines 6 and 8, Table 1).

Table 2 shows the revenue derived by the state governments from all taxes on the income of individuals during four of the fiscal years between 1970 and 1976. Table 2 does *not* include any revenues of the local governments, due to the difficulty in collecting a complete set of such data.[18] In both 1970—71 and 1972—73 the revenue from taxes on individual income in the six states ranged from approximately 6 percent to 15 percent of state government recurrent revenue. From 1972—73 to 1974—75 the percentage importance of such revenue

17. Therefore, the abolition of the cattle tax in 1975 was noticed most acutely there.

18. Therefore, in contrast to Table 1, only the *state* government share — 12.5 percent to 20 percent — of community and cattle tax revenue is included in Table 2.

decreased in all these states. In fact, the actual decreases are greater than those shown in Table 2 inasmuch as the numbers shown there are the budget *estimates*, which were drawn up prior to the Federal government's imposition of uniform personal income tax rates and deductions on April 1, 1974. Without exception, the effect of the uniform rates was to decrease the amount of revenue actually collected by the states from this source in 1974-75. [19] The amount of estimated income taxation revenue for 1975—76 does decrease in *absolute* terms in five of the six states under discussion here, and in all six states it declines very dramatically as a *proportion* of total revenue. Only in Benue-Plateau state in 1975—76 did such revenue approach 2.5 percent of recurrent revenue. That decrease resulted from the revised system of revenue allocation that began to function on April 1, 1975, by which sizeable amounts of the much-increased Federal government revenues were granted to the states. That change in the revenue allocation system followed the four-fold O.P.E.C. price increases of late 1973 and early 1974 and the resultant increases in Federal government oil revenues, and statutory grants for 1975—76 ranged from 50 to 90 percent of state recurrent revenue. [20] Indeed, it was the buoyancy of petroleum-based government revenues — and the accompanying changes in the revenue allocation system — that permitted the uniformity of personal income taxation and the accompanying loss of such revenue to the states to be economically and politically feasible.

## TABLE 2

**State revenue from all taxes on the income of individuals in Nigeria — Selected states and years**

| *State* | 1970–71 | | | 1972–73 | | | 1974–75* | | | 1975–76* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | State revenue from all taxes on income of individuals (₦ million) | Total state recurrent revenue (₦ million) | (%) | State revenue from all taxes on income of individuals (₦ million) | Total state recurrent revenue (₦ million) | (%) | State revenue from all taxes on income of individuals (₦ million) | Total state recurrent revenue (₦ million) | (%) | State revenue from all taxes on income of individuals (₦ million) | Total state recurrent revenue (₦ million) | (%) |
| Benue-Plateau | 1.400 | 19.457 | 7.2 | 2.250 | 24.486 | 9.2 | * 3.190 | 41.182 | 7.8 | * 2.900 | 119.852 | 2.4 |
| Kano | 3.184 | 31.242 | 10.2 | 3.125 | 33.512 | 9.3 | * 2.630 | 43.036 | 6.1 | * 3.300 | 147.783 | 2.2 |
| Kwara | .970 | 16.735 | 5.8 | * 1.164 | 18.692 | 6.2 | * 1.725 | 32.881 | 5.3 | * .760 | 96.858 | 0.8 |
| North Cen. | 2.852 | 22.840 | 12.5 | 3.985 | 26.808 | 14.9 | * 3.452 | 43.187 | 8.0 | * 2.090 | 121.975 | 1.7 |
| North East. | 2.150 | 30.436 | 7.1 | * 2.630 | 35.899 | 7.3 | * 2.221 | 55.384 | 4.0 | * 1.450 | 161.300 | 0.9 |
| North West. | * 1.276 | 17.586 | 7.3 | * 1.842 | 29.362 | 6.3 | * 2.090 | 41.911 | 5.0 | * 1.559 | 145.767 | 1.1 |
| TOTAL | 11.832 | 138.296 | 8.6 | 14.996 | 168.759 | 8.9 | 15.308 | 257.581 | 5.9 | 12.059 | 793.535 | 1.5 |

*Source:* Various state Budget *Estimates.*

The amounts for all states and years indicated by an asterisk (*) are Approved Estimates.

State revenue from all taxes on income of individuals includes personal income tax (P.A.Y.E. and Direct Assessment), and state share of community tax and cattle tax.

## THE EFFECT OF UNIFORM INCOME TAXATION ON TAXPAYERS

The apparent intention when the uniform system of progressive-rate personal income taxes was introduced was to lower the average rates of tax. However, the earlier-discussed decline in total income tax revenue collected does not mean that the amount paid by *each* taxpayer decreased. The *average* rate of tax (total tax liability divided by total pre-tax income) depends on the kind and amount of tax reliefs allowed as well as the marginal rates of tax (the *change* in the tax liability divided by the *change* in chargeable income). The tax rates shown in Appendix Table A-1 are *marginal* rates, and apply to *chargeable* income after any allowable deductions or reliefs are subtracted from the taxpayer's total income. In Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states the larger deductions caused more significant reductions in the total tax liability for most taxpayers than did the changes in the marginal rates of tax. However, it is *not* the case that all taxpayers in these states experienced reduced tax liabilities.

19. The Federal government budget for 1975—76 provides for a Federal non-statutory grant to the then-twelve state governments of 25 million Naira to reimburse them for decreased Pay As You Earn personal income tax revenue that they experienced in fiscal 1974—75. For Benue-Plateau, Kano, Kwara, and North Central states, where that item is shown separately in their own budgets, it amounts to 8.25 million Naira.

20. Lawrence A. Rupley, "Revenue Allocation in Nigeria," *West Africa*, No. 3025 (June 16, 1975), p. 681.

Prior to April 1, 1974, a consolidated personal allowance or personal allowance [21] of 480 Naira could be deducted in arriving at the taxpayer's chargeable income, as well as life insurance premiums and some education expenses for children. [22] The changes introduced on April 1, 1974, generally increased the number and size of deductions allowed in Benue-Plateau, Kano, Kwara, North Central, North Eastern and North Western states. A deduction of 600 Naira to the income earner replaced the 480 Naira consolidated personal allowance for men or personal allowance for women income earners. The deduction allowed the taxpayer for a wife of 300 Naira was new, as was the deduction for children of 250 Naira each (to a maximum of 1,000 Naira). All these deductions had the effect of reducing the tax liabilities of those taxpayers who were eligible to deduct them. Life insurance premiums continued to be deductible, [23] as did the costs of earning income (e.g., a proprietor's business expenses) and contributions to an approved retirement fund. The deduction for education expenses for children was eliminated.

For illustration, the average tax rates for individuals (total tax liability divided by total pre-tax income) before and after the changes to the uniform system as of April 1, 1974, have been calculated for several income levels and appear in Appendix Table A-4. In Benue-Plateau, Kwara, North Central, North Eastern and North Western states prior to April 1, 1974, the absence of any deductions for a wife or for children make the average rates of tax identical for a taxpayer who is unmarried, married with no children, or married with either 2 or 4 children. [24] The introduction of such deductions in the uniform system of April 1, 1974, means that average rates are lower for taxpayers with four children than with two, lower with two children than with none, and lower for a married taxpayer than for an unmarried one.

## TABLE 3

**Effect of April 1, 1974, uniform personal income tax rates and deductions on average tax rates paid by some representative taxpayers in Benue-Plateau, Kwara, North Central, North Eastern and North Western States**

| Taxpayer | | Decrease in average rates on incomes of (₦) | No change in average rates on incomes of (₦) | Increase in average rates on incomes of (₦) |
|---|---|---|---|---|
| (A) | Unmarried individual, Personal deduction of 600 Naira | 481 – 799, 4,121 and above | 0 – 480, 800, 4,120 | 801 – 4,119 |
| (B) | Married taxpayer with no children, husband the only income earner, personal deduction of 600 Naira, deduction for a wife, 300 Naira | 481 – 1,839, 2,641 and above | 0 – 480, 1,840, 2,640 | 1,841 – 2,639 |
| (C) | Married taxpayer with two children, husband the only income earner, personal deduction of 600 Naira, deduction for a wife 300 Naira, deduction for two children 500 Naira | 481 and above | 0 – 480 | – |
| (D) | Married taxpayer with four children, husband the only income earner, personal deduction of 600 Naira, deduction for a wife 300 Naira, deduction for four children 1,000 Naira | 481 and above | 0 – 480 | – |
| (E) | Married taxpayer with two children, wife earns 1,000 Naira of the total income, personal deduction, husband, 600 Naira, deduction for a wife 300 Naira, deduction for two children 500 Naira, personal deduction, wife, 600 Naira | 1,601 and above | 1,600 | 1,000 – 1,599 |

Income amounts are total pre-tax income before any deductions are taken into account.

In calculating average tax rates prior to April 1, 1974, only the consolidated personal allowance of 480 Naira is deducted to arrive at chargeable income for Taxpayers A, B, C, D. That 480 Naira plus the personal allowance of 480 Naira is deducted for Taxpayer E. The various deductions after April 1, 1974, are shown as part of the description of the several taxpayers.

Calculations are by author.

21. The consolidated personal allowance applied to men and the personal allowance to women. However, the personal allowance was not granted automatically; the Commissioner of Revenue had to be satisfied that the income belonged to her before the personal allowance was granted to a woman income earner.
22. A deduction to a maximum of 500 Naira per child and 1,000 Naira overall, was allowed for children in school overseas or in university education inside or outside Nigeria.
23. See Appendix Table A-1.
24. These examples assume that no educational expenses are incurred for the children.

Table 3 summarizes the income ranges for which average tax rates are unchanged, reduced, or increased as a result of the uniform system of April 1, 1974. It is not correct to presume that the system of tax rates and deductions in existence prior to April 1, 1974 in these five states was itself optimum. The desire for equity or fairness in taxation must be balanced against the need for revenue. Clearly, if average rates of tax are reduced, the revenue yield will be lowered. It is evident from Table 3 that the major impact of the uniform system was to leave unchanged or to lower the average rates of tax. [25] However, the average tax rates for some income ranges for unmarried taxpayers or married taxpayers with no children increased (Taxpayers A and B in Table 3). It is not altogether clear why average tax rates should increase for an unmarried taxpayer (Taxpayer A) with income of 801 Naira to 4,119 Naira while they are decreased above 4,120 Naira. Similarly, why should the uniform system mean that a married taxpayer with no children (Taxpayer B) with income of 1,841 Naira to 2,639 Naira pays higher average rates while such a taxpayer with income above 2,640 Naira finds his average tax liability reduced. These two cases are particularly noticeable inasmuch as married taxpayers with two or more children (illustrated by Taxpayers C and D) experience decreased tax liabilities throughout all income levels above 480 Naira. [26]

Perhaps an even more important continuing question regarding equity in income taxation concerns the fairness of a system in which some taxpayers — those in wage employment where the tax is withheld by the employer through P.A.Y.E. — pay the tax, while others who are self-employed and are therefore not subject to the P.A.Y.E. system may be able to evade such taxation to a large extent. It is possible to argue that *lower* average rates of income tax *may* stimulate improved voluntary compliance by the self-employed, and thus lead to a decrease in this inequity. However, given the uncertainty as to the success of such an approach — and the fact that if carried to its logical extreme the revenue raised would be zero — other steps should continue to be taken to improve the tax compliance of the self-employed. [27]

## CONSIDERATIONS FOR THE FUTURE

First and foremost, personal income-based taxation has been important as a revenue source to provide funds for government expenditure plans, an important part of which was seen as necessary to encourage economic development. In addition to the long-standing pattern of expenditure on health, education, roads and administration by state and local governments, the revenue from income-based taxation has provided part of the funding for projects to process agricultural output, for the supply of fertilizers and seeds, and water management and agricultural credit programs. It has also been used to finance the provision of industrial estates and for manufacturing investment in firms engaged in all sorts of production, including cement, bricks, starch, textiles, tanned leather, soap, sawn lumber, and glass. Many of the state governments bought formerly-private firms following the Indigenisation Decree. Governments in Nigeria have clearly regarded their expenditure to be important in the modernization and industrialization of their economies, and the desired magnitude of such expenditure — and the necessary revenue to finance it — is not likely to decrease in the foreseeable future.

The personal and cattle tax were intended to force subsistence farmers and herdsmen to enter the monetary economy at least to the extent that they had to secure sufficient cash receipts to pay their taxes. Such taxation also contributed to mobilization of more total savings — in the hands of the government — than would have occurred otherwise. The broad-based, simple personal tax tends to encourage income-earning activity — investment and work-effort — among small-scale farmers since the amount of the tax liability is related to the individual's presumed income, and his tax liability does not immediately rise if he should earn more than the amount estimated by the tax collector. The personal tax has been important as it has helped spread the taxpaying habit among a relatively large proportion of the population in Nigeria's northern states. [28] On balance, it would seem desirable to continue the use of such taxation in Nigeria.

The fact that the personal tax covers a relatively large number of taxpayers has important implications for tax equity. Nearly everyone, even where the average income level is extremely low, has *some* taxpaying ability and therefore, under the ability to pay equity principle, nearly everyone should pay *some* amount of tax. This is

25. This is also shown by the fact that total income tax revenue decreased as a result of the changes.

26. The tax liability for those with incomes from zero to 480 Naira was zero both before and after the introduction of the uniform system.

Although the marginal tax rates on chargeable income above 10,000 Naira were raised as of April 1, 1977, the personal deduction applicable for earned income was also increased. Much of the effect of the higher marginal rates is thereby offset. For example, if all Taxpayer D's income were earned income, the average rate of tax for which he is liable does not exceed that under the system in Benue-Plateau, Kwara, North Central, North Eastern, and North Western states prior to April 1, 1974, until his total income is something in excess of 50,000 Naira.

27. One such desirable step was the provision introduced as of April 1, 1977, whereby self-employed individuals in the construction industry are to be taxed the higher of the tax liability calculated in the normal way or 2.5 percent of gross sales. Since the value of contracts awarded to construction firms is often a matter of public information, it is somewhat harder to conceal the value of gross sales than it is to "adjust" reported net profits downward.

28. Prest points out that in many less developed countries less than 5 percent of the population pay personal income taxes. Prest, *Public Finance in Underdeveloped Countries* (2nd ed.), p. 34.

Although hard data on the number of taxpayers is scarce, it seems plausible that in the northern states of Nigeria at least twice the proportion suggested by Prest paid one of the three income-based taxes. However, taxpayer protests against the personal tax from time to time in Nigeria and the small amounts of progressive personal income tax collected through direct assessment of self-employed high income individuals where voluntary taxpayer compliance is extremely important remind one that the expansion of the use of income taxation will not occur automatically.

important in economies where only a small proportion of the population is engaged in wage employment [29] and much of the rural population consumes very small quantities of imported or domestic manufactured goods. In such cases, progressive-rate personal income taxes and customs and excise duties are paid by only a tiny segment of the population. [30] It is, of course, necessary to see that higher-income self-employed individuals also pay taxes according to their ability to pay if equity is to be achieved. [31]

It seems unlikely that the personal tax will provide a GNP-elastic source of revenue due to the low ceiling rates of tax applied. However, a low revenue elasticity with respect to GNP may be no worse than the revenue performance of other apparently-progressive taxes if such taxes only apply to, say, 3 or 5 percent of the income or transactions in an economy dominated by small-scale agriculture. [32]

One unwise feature when the uniform progressive-rate personal income tax was introduced was its timing. Although the intention to introduce such a system was announced in the April 1, 1974, Federal Budget Speech, the Decree to implement the system was not published until February 24, 1975, but was made retroactive to April 1, 1974. [33] By the time the necessary P.A.Y.E. tax tables were made available to employers, it meant a recalculation of income tax liabilities over 11 or 12 months of the fiscal year. That feature added directly to the work-load of the payroll departments of firms, governments, and universities, many of which were just beginning to emerge from the strain of the calculations of the "Udoji" award arrears payments and conversions to new salary and wage tables in early 1975. If the government felt that a promise had been made to implement a uniform personal income taxation system during 1974—75, then an announcement in February, 1975, of such a system to become operative as of March 1, 1975, would have fulfilled that promise adequately. The administrative feasibility of such a plan would have more than compensated for any possible disgruntlement with the delay in its introduction. Attempts should be made in the future to avoid such retroactive changes.

The abundance of petroleum revenues certainly *permitted* the uniformity in progressive personal income taxation to be imposed by the Federal government. Centralization of the control of this revenue source would have been resisted much more strongly by the state governments if the petroleum revenues had not enabled the Federal government to make much larger grants to them. There is a danger that a decrease in the number of revenue sources *controlled* by the state governments since 1970 — e.g., cattle tax, progressive personal income tax — may have an adverse effect on the *tax effort* that they make. This would occur it the state governments come to rely nearly exclusively on petitions to the Federal government to alleviate their every additional revenue need or to correct for errors or irresponsibility in budgeting rather than try to tap those revenue sources under their own control. [34] One must seek to balance the advantages of reduced cost or increased efficiency due to central collection of some revenues against the desire to encourage adequate tax effort by all levels of government.

Up to the present time personal income-based taxation has not played a significant role as a tool for centralized fiscal stabilization in Nigeria. That was particularly true when such taxation was levied separately by each state. At present, petroleum revenues completely dwarf personal income taxes in importance — as they do all other non-petroleum sources — so that deliberate changes in income taxation would have very little fiscal impact on aggregate economic behavior. However, the growth of petroleum revenues has leveled out following the dizzying two-and-one-half-fold climb from early 1974 to 1975, [35] and the search for alternative sources is on again. [36] It would be extremely premature to conclude that personal income-based taxation has no future fiscal role in Nigeria over, say, the next 30 years given the possible changes in the structure of the economy and its resource base that the future may hold.

29. The 1966—67 Labor Force Sample Survey in Nigeria showed that only 5 percent of all gainfully employed persons were employees. World Bank, *Nigeria: Options for Long-Term Development*, p. 28.

30. For example, calculations derived by this author from a consumption survey of 120 households during 1970 and 1971 in three villages near Zaria suggest that excise duties on cloth, cigarettes and kerosene were the only significant expenditure taxes paid by such rural households. *Extremely* small amounts of expenditure on matches, salt, soap, cosmetics and scent, sugar, tea, bread, evaporated milk, candy, and occasional durable good purchases such as a bicycle, also were therefore subject to import or excise duties. E.B. Simmons, "Rural Household Expenditures in Three Villages of Zaria Province, May, 1970 — July 1971," *Samaru Miscellaneous Paper 56*, Institute for Agricultural Research, Ahmadu Bello University, Zaria, 1976.

31. For example, low-income farmers who produced export crops in Nigeria bore very substantial tax burdens through export and produce sales taxation prior to the elimination of such taxes in 1973 and 1974.

32. In all the six northern states, much more revenue has been derived from the community tax than from direct assessment of the progressive income tax on self-employed individuals. Merely the *state* government's share of the personal tax revenue for those states exceeded the revenue from the directly assessed progressive income tax by at least 2 times in every year from 1970 through 1975.

33. Nigeria, Income Tax Management (Uniform Taxation Provisions, Etc.) Decree 1975 (Decree No. 7 of 1975), *Official Gazette*, Vol. 62, No. 9, 24 February 1975.

34. Although neither the 1978-79 Budget Speech nor the report of the Technical Committee on Revenue Allocation (which includes independent revenue and tax effort and fiscal efficiency as criteria for revenue division) lead one to think that extraordinary petitions by the states will meet with great success.

35. See Lawrence A. Rupley, "Budgetary Trends in Nigeria," *West Africa*, No. 3100 (November 29, 1976), pp. 1810, 1811.

36. All states in Nigeria showed deficits in their 1977—78 budgets, and the 1978—79 Federal and state budgets showed either decreases in expenditure or deficits due to the revenue constraint because of decreased oil production.

Oil's contribution to Federal revenue has decreased from 80 percent to 62 percent in the 1978—79 budget according to Federal Commissioner for Finance Oluleye, and the government intends to bring it below 40 percent. His remarks were made during the establishment of a task force that is to recommend ways to increase income tax collections, *West Africa*, No. 3173 (May 8, 1978), p. 904.

# Appendix

## TABLE A-1

### Uniform personal income tax rates, Nigeria

| Chargeable income | Rate of tax | |
|---|---|---|
| | April 1,1974 - March 31,1977 | As of April 1,1977 |
| ₦ 0 - 2,000 | 10k per Naira or 10% | 10% |
| 2,001 - 4,000 | 15k per Naira or 15% | 15% |
| 4,001 - 6,000 | 20k per Naira or 20% | 20% |
| 6,001 - 8,000 | 25k per Naira or 25% | 25% |
| 8,001 - 10,000 | 30k per Naira or 30% | 30% |
| 10,001 - 15,000 | 35k per Naira or 35% | 40% |
| 15,001 - 20,000 | 40k per Naira or 40% | 45% |
| 20,001 - 30,000 | 45k per Naira or 45% | 55% |
| over 30,000 | 50k per Naira or 50% | 70% |

The following deductions are allowed from the taxpayer's total income in any year of assessment to arrive at his chargeable income.

1) A ₦ 600 deduction is allowed to the individual who earns the income.
2) A ₦ 300 deduction is allowed to a married man for a wife living with or maintained by him during the preceding year (or alimony paid to a former spouse up to a maximum of ₦ 300).
3) A ₦ 250 deduction is allowed for each unmarried child maintained by the individual during the preceding year if the child was less than 16 years of age or was a full-time student in school or in a trade or professional apprenticeship. Such a deduction is allowed for a maximum of four children.
4) A deduction is allowed for the costs of maintaining a close relative of the individual or of the individual's spouse in the preceding year if such a relative was incapacitated by old age or infirmity from maintaining himself and his income was less than ₦ 600 for that year. The same provisions apply to the individual's or individual's spouse's widowed mother, whether incapacitated or not. The aggregate deductions of this kind for any one individual taxpayer shall not exceed ₦ 400.
5) A deduction is allowed for premiums paid on life insurance policies in the preceding year which secure a capital sum on death on the life of the individual or the individual's spouse. The deduction may not exceed 10 percent of the capital sum of the policy, nor ₦ 2,000 per individual per year, nor 20 percent of the individual's total income.

*Source*: Nigeria, Income Tax Management (Uniform Taxation Provisions, Etc.) Decree 1975 (Decree No. 7 of 1975), ***Official Gazette***, Vol. 62, No. 9, 24th February, 1975.
Source for changes on April 1, 1977: Nigeria, Finance (Miscellaneous Taxation Provisions) (No. 2), Decree 1977 (Decree No. 61 of 1977), ***Official Gazette***, Vol. 64, No. 43, 1st September, 1978.

## TABLE A-2

### Income tax rates immediately prior to the introduction of uniform system as of April 1, 1974 – Selected states of Nigeria

**Benue-Plateau, Kwara, North Central, North Eastern, North Western States**

| Chargeable income (₦) | Marginal tax rate (%) |
|---|---|
| 0 – 1,000 | 6.25 |
| 1,001 – 2,000 | 8.75 |
| 2,001 – 3,000 | 15.0 |
| 3,001 – 4,000 | 20.0 |
| 4,001 – 6,000 | 25.0 |
| 6,001 – 8,000 | 32.5 |
| 8,001 – 10,000 | 40.0 |
| Over 10,000 | 50.0 |

*Source:* Northern Nigeria, Personal Tax Law of 1962.

**Kano State**

| Chargeable income (₦) | Marginal tax rate (%) |
|---|---|
| 0 – 1,200 | 5 |
| 1,201 – 2,400 | 10 |
| 2,401 – 3,600 | 15 |
| 3,601 – 4,800 | 20 |
| 4,801 – 6,000 | 25 |
| 6,001 – 7,000 | 30 |
| 7,001 – 8,000 | 35 |
| 8,001 – 9,000 | 40 |
| 9,001 – 10,000 | 50 |

*Source:* Kano State, *Official Gazette,* Vol. 6, No. 13, 18 May 1972. These rates became effective on April 1, 1972.

## TABLE A-3

**Total income-based tax revenue, state and local governments, 1972–73**
**Benue-Plateau, Kano, Kwara, North Central, North Eastern, North Western States of Nigeria**

(₦ million)

| | Benue Plateau | Kano | Kwara | North Central | North Eastern | North Western | Total Six States |
|---|---|---|---|---|---|---|---|
| 1. Total Recurrent Revenue – State Government | 24.486 | 33.512 | 18.692 | 26.808 | 35.899 | 29.362 | 168.759 |
| 2. Total Recurrent Revenue – Local Governments | 5.446 | 5.268 | 3.144 | 6.346 | 9.851 | 7.212 | 37.267 |
| 3. Total (lines 1 + 2) State & Local Recurrent Revenue | 29.932 | 38.780 | 21.836 | 33.154 | 45.750 | 36.574 | 206.026 |
| 4. Progressive-Rate Personal Income Tax – State | 1.500 | 2.487 | .900 | 3.256 | 1.070 | .582 | 9.795 |
| 5. Community Tax – State Share | .710 | .593 | .254 | .661 | 1.200 | 1.100 | 4.518 |
| 6. Community Tax – Local Share | 3.902 | 3.976 | 2.014 | 4.578 | 6.719 | 5.914 | 27.103 |
| 7. Total (lines 5 + 6) | 4.612 | 4.569 | 2.268 | 5.239 | 7.919 | 7.014 | 31.621 |
| 8. Cattle Tax – State Share | .040 | .045 | .010 | .067 | .360 | .160 | .682 |
| 9. Cattle Tax – Local Share | .294 | .300 | .070 | .392 | 1.896 | .568 | 3.520 |
| 10. Total (lines 8 + 9) | .334 | .345 | .080 | .459 | 2.256 | .728 | 4.202 |
| 11. Total (lines 4 + 7 + 10) | 6.446 | 7.401 | 3.248 | 8.954 | 11.245 | 8.324 | 45.618 |
| 12. Income-Based Taxes as Percent of Total State & Local Recurrent Revenue (11 ÷ 3) | 21.5% | 19.1% | 14.9% | 27.0% | 24.6% | 22.8% | 22.1% |

*Source:* Various state and local government Budget *Estimates.* Calculations are by author.

All local government revenue amounts are Approved Estimates; state government revenue amounts are actual wherever possible, otherwise Approved Estimates.

The fiscal year for all governments is April 1 through March 31.

## TABLE A-4

**Average tax rates at various total income levels**
**Benue-Plateau, Kwara, North Central, North Eastern, North Western States**

| Total Income (₦) | Average Tax Rates Immediately Prior to April 1, 1974 (%) | Average Tax Rates After April 1, 1974 (%) | | | |
|---|---|---|---|---|---|
| | Taxpayers A, B, C, D | Taxpayers A | B | C | D |
| 1,000 | 3.25 | 4.0 | 1.0 | -0- | -0- |
| 2,000 | 5.4 | 7.0 | 5.5 | 3.0 | 0.5 |
| 3,000 | 7.6 | 8.7 | 7.2 | 5.3 | 3.7 |
| 4,000 | 10.1 | 10.25 | 9.1 | 7.25 | 5.4 |
| 10,000 | 22.6 | 18.2 | 17.3 | 15.8 | 14.3 |

Total income is that before any deductions are subtracted.

Taxpayer A is an unmarried individual.

Taxpayer B is a married individual with no children.
Taxpayer C is a married individual with two children.
Taxpayer D is a married individual with four children.

In the calculation of average tax rates prior to April 1, 1974, only the consolidated personal allowance of ₦ 480 is deducted to arrive at chargeable income for A, B, C, D.

In the calculation of average tax rates after April 1, 1974, the personal deduction of ₦ 600 is allowed for A, B, C, D; the deduction for a wife of ₦ 300 is allowed for B, C, D; a deduction for two children of ₦ 500 is allowed for C; and a deduction for four children of ₦ 1,000 is allowed for D.

Calculations are by author.

# COMECON BEATS E.E.C.

## Conclusion of a multilateral treaty for the avoidance of double taxation

In May 1977, a meeting of financial experts of the Comecon-Member States took place is Miskolc (Hungary), resulting in a draft of a multilateral treaty for the avoidance of double taxation with respect to taxes on income and net worth of individuals resident in one or more of these States. The treaty was open to signature until July 31, 1977. To date, 8 countries have adhered to the Convention, i.e. the U.S.S.R., Poland, the German Democratic Republic, Czechoslovakia, Hungary, Romania, Bulgaria and Mongolia; however, other countries can also adhere to the Convention upon approval of all treaty parties concerned.

The first country which ratified the Convention was Romania. [1] It is expected that the treaty will enter into force on January 1, 1979.

Awaiting a thorough discussion of the Convention which will be published in a future issue of the Bulletin, the International Bureau of Fiscal Documentation is pleased to publish an unofficial English translation of the Convention below. [2]

### CONVENTION

#### With respect to the avoidance of double taxation on income and net worth of individuals

The Contracting States,
Wishing to contribute to an increased and strengthened continuation of economic, technical-scientific and cultural cooperation between their countries and tending to improve the mechanism of their financial and currency relations, in consideration of the creation of more favorable, uniform conditions in the process of economic and technical-scientific cooperation and cultural exchange, have agreed as follows:

**Article I**

1. This Convention refers to individuals who have a permanent residence in the territory of the Contracting States.

2. If it is not possible, from the point of view of taxation, to determine the permanent residence of an individual in accordance with paragraph 1 of this article, then the permanent residence of such a person, in the sense of this Convention, shall be deemed to be the country of which he is a national.

3. If it is not possible to determine the permanent residence of an individual in accordance with paragraph 2 of this article, this problem shall be solved by mutual agreement between the competent authorities of the respective Contracting States. Competent authorities, in the sense of this Convention, are the Ministers of Finance of the countries of the Contracting States.

**Article II**

This Convention shall apply to all categories of levies and taxes imposed on the income and net worth of individuals in the territory of the Contracting States in accordance with their laws.

**Article III**

Starting from the principle that individuals may not be subject to concurrent taxation, with respect to the same income and net worth, on the territory of two or more Contracting States, the following provisions shall apply:

a) individuals employed by authorities or organizations of the Contracting States as commercial and transport agents, or otherwise acting as their representative or agent, including correspondents and employees working at an information center, in the territory of any other Contracting State, shall be subject, in the country of establishment, to levies and taxes on remunerations and other payments received by that representative or agent. Accordingly, this provision shall also apply to employees of Inter-State organizations and other international organizations (except those mentioned in paragraph b) of this article), sent out to work for those organizations from countries which are not the country of residence of the relevant organizations;

b) individuals who work in the territory of the Contracting States for international economic organizations which are engaged in the development of principles of economic administration, are subject to levies and taxes on remunerations and other payments received from such organizations, in accordance with the law of the country in which the relevant organization has its seat, only if this does not otherwise follow from any *constitutive* act or other special agreement;

c) individuals employed by virtue of an agreement betweeen Contracting States on the territory of any other Contracting State for giving technical assistance or for rendering services of a similar nature shall be liable in the country in which they stay for the payment of levies and taxes on remunerations and other payments received from the authority or organization of the country in which the activities are carried out, that payment shall be subject to levies and taxes in accordance with the law of that country, with the exception of daily allowances and allowances for the costs of accommodation;

d) individuals who move within one of the countries of this Convention for study, training, giving consultation and other similar activities, and who receive remunerations and other payments directly from the authority or organization of that country, are subject to taxes and levies on that payment in accordance with the law of the relevant country, with the exception of daily allowances and allowances for the costs of accommodation. Remunerations and other payments received by individuals, mentioned in this paragraph, from the

1. Published in the Romanian Official Gazette (BULETINUL OFICIAL), Part I, No. 16, item 60 of March 6, 1978.
2. Prepared by Mr. W.G. Kuiper, Staff Member of the International Bureau of Fiscal Documentation.

authorities or an organization of the country in which they have their permanent residence, are subject to levies and taxes in that country, provided that it has become a party of this Convention;

e) income of an individual derived from authors' rights, from utilization of literary, scientific and artistic works on the territory of any Contracting State, as well as remunerations paid for scientific or technical inventions, industrial designs and for general use thereof, proposals for rationalization and other similar things, is subject to levies and taxes in accordance with the law of the country in which that individual has his permanent residence;

f) individuals who move within one of the countries which have become a party to this Convention for the holding of lectures and reports, for theater performances, concerts, sports manifestations and other such activities are subject to levies and taxes, in the country of receipt, on remunerations, emoluments and other payments received from the authority and organization of the country in which they have their permanent residence. If such a payment is made to individuals by the authority or organizations of the host-country, that payment is subject to levies and taxes in accordance with the law of that country;

g) immovable and movable property of individuals, inclusive of income from utilization thereof, inheritances, gifts, rentals, sale and exchange of that property, is subject to levies and taxes in accordance with the law of the country in which that property is situated.

### Article IV

The provisions of this Convention do not exclude the possibility of providing for supplementary privileges in tax matters, by the Contracting States, either on the basis of mutual agreement or unilaterally.

### Article V

This Convention does not restrict the rights of the Contracting States to subject individuals to levies and taxes, as long as this does not conflict with the provisions of this Convention.

### Article VI

The provisions of this Convention do not affect fiscal privileges of official diplomatic and consular persons who are appointed in accordance with the general rules of international law or by virtue of a special international agreement.

### Article VII

Becoming a party to this Convention does not affect conventions in force regarding taxation which have previously been concluded by the Contracting States.

However, if the provisions of such a convention are in contradiction with the provisions of this Convention, the provisions of this Convention shall apply.

### Article VIII

Problems which may arise in connection with the application of this Convention shall be solved by means of negotiations and consultations between the Ministers of Finance of the interested Contracting States.

### Article IX

This Convention is subject to approval in conformity with the law of each Contracting State and will enter into force on the 1st of January of the year following the year in which the documents of approval of the Convention by all Contracting States will have been received by the body in charge.

### Article X

1. This Convention is concluded for an unlimited period of time.

2. After having passed a period of time of 5 years as of the date of the entry into force of this Convention, each Contracting State can renounce being a party to this Convention by informing the body in charge in connection with the renouncement of this Convention to that effect, at least 6 months before the end of the calendar year. In that case, the validity of the Convention will cease, with regard to the respective Contracting State, as of the 1st of January of the year following the year in which the information of the renouncement from this Convention was made.

### Article XI

Upon approval of all parties concerned, other countries can adhere to this Convention by presenting to the body in charge the documents of adhesion. Adhesion shall be deemed to take place on the 1st of January of the year following the year in which the body in charge will have received a notice from all countries which are a party to this Convention regarding their approval with respect to the adhesion.

### Article XII

This Convention can be modified or completed with the consent of all Contracting States.

### Article XIII

This Convention remains open for signing until July 31, 1977 in the city of Moscow.

### Article XIV

This Convention is passed on for supervision to the Secretariat of the Council for Mutual Economic Assistance which will act as body in charge of this Convention.

Signed in the town of Miskolc (People's Republic of Hungary), this 27th day of May 1977, in singular, in the Russian language.

Plenipotentiary of the People's Republic of Bulgaria, B. Belcev
Plenipotentiary of the People's Republic of Hungary, L. Faluvégi
Plenipotentiary of the German Democratic Republic, R. Mager
Plenipotentiary of the People's Republic of Mongolia, T. Molom
Plenipotentiary of the Socialist Republic of Romania, Fl. Dumitrescu
Plenipotentiary of the Czechoslovak Socialist Republic, L. Lér
Plenipotentiary of the Union of Socialist Soviet Republics, V. Garbusov
Plenipotentiary of the Polish People's Republic, M. Krzak

# OECD MODEL CONVENTION/ OECD MUSTERABKOMMEN 1977

# (German text)*

## ÜBERSCHRIFT DES ABKOMMENS

**Abkommen zwischen (Staat A) und (Staat B) zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen**

## PRÄAMBEL DES ABKOMMENS

**Anmerkung:**
**Die Präambel des Abkommens richtet sich nach den verfassungsrechtlichen Verfahren der beiden Vertragsstaaten**

### ABSCHNITT I
Geltungsbereich des Abkommens

**Artikel 1**
*Persönlicher Geltungsbereich*

Dieses Abkommen gilt für Personen, die in einem Vertragsstaat oder in beiden Vertragsstaaten ansässig sind.

**Artikel 2**
*Unter das Abkommen fallende Steuern*

(1) Dieses Abkommen gilt, ohne Rücksicht auf die Art der Erhebung, für Steuern vom Einkommen und vom Vermögen, die für Rechnung eines Vertragsstaats oder seiner Gebietskörperschaften [1] erhoben werden.

(2) Als Steuern vom Einkommen und vom Vermögen gelten alle Steuern, die vom Gesamteinkommen, vom Gesamtvermögen oder von Teilen des Einkommens oder des Vermögens erhoben werden, einschliesslich der Steuern vom Gewinn aus der Veräusserung beweglichen oder unbeweglichen Vermögens, der Lohnsummensteuern sowie der Steuern vom Vermögenszuwachs.

(3) Zu den bestehenden Steuern, für die das Abkommen gilt, gehören insbesondere
a) (in Staat A): ...
b) (in Staat B): ...

(4) Das Abkommen gilt auch für alle Steuern gleicher oder im wesentlichen ähnlicher Art, die nach der Unterzeichnung des Abkommens neben den bestehenden Steuern oder an deren Stelle erhoben werden. Die Zuständigen Behörden der Vertragsstaaten teilen einander am Ende eines jeden Jahres die in ihren Steuergesetzen eingetretenen Änderungen mit.

### ABSCHNITT II
Begriffsbestimmungen

**Artikel 3**
*Allgemeine Begriffsbestimmungen*

(1) Im Sinne dieses Abkommens, wenn der Zusammenhang nichts anderes erfordert,
a) umfasst der Ausdruck "Person" natürliche Personen, Gesellschaften und alle anderen Personenvereinigungen;
b) bedeutet der Ausdruck "Gesellschaft" juristische Personen oder Rechtsträger, die für die Besteuerung wie juristische Personen behandelt werden;
c) bedeuten die Ausdrücke "Unternehmen eines Vertragsstaats" und "Unternehmen des anderen Vertragsstaats", je nachdem, ein Unternehmen, das von einer in einem Vertragsstaat ansässigen Person betrieben wird, oder ein Unternehmen, das von einer im anderen Vertragsstaat ansässigen Person betrieben wird;
d) bedeutet der Ausdruck "internationaler Verkehr" jede Beförderung mit einem Seeschiff oder Luftfahrzeug, das von einem Unternehmen mit tatsächlicher Geschäftsleitung in einem Vertragsstaat betrieben wird, es sei denn, das Seeschiff oder Luftfahrzeug wird ausschliesslich zwischen Orten im anderen Vertragsstaat betrieben;
e) bedeutet der Ausdruck "zuständige Behörde"
i) (in Staat A): ...
ii) (in Staat B): ...

(2) Bei der Anwendung des Abkommens durch einen Vertragsstaat hat, wenn der Zusammenhang nichts anderes erfordert, jeder im Abkommen nicht definierte Ausdruck die Bedeutung, die ihm nach dem Recht dieses Staates über die Steuern zukommt, für die das Abkommen gilt.

**Artikel 4**
*Ansässige Person*

(1) Im Sinne dieses Abkommens bedeutet der Ausdruck "eine in einem Vertragsstaat ansässige Person" eine Person, die nach dem Recht dieses Staates dort auf Grund iheres Wohnsitzes, ihres ständigen Aufenthalts, des Ortes ihrer Geschäftsleitung oder eines anderen ähnlichen Merkmals steuerpflichtig ist. Der Ausdruck umfasst jedoch nicht eine Person, die in diesem Staat nur mit Einkünften aus Quellen in diesem Staat oder mit in diesem Staat gelegenem Vermögen steuerpflichtig ist.

(2) Ist nach Absatz 1 eine natürliche Person in beiden Vertragsstaaten ansässig, so gilt folgendes:
a) Die Person gilt als in dem Staat ansässig, in dem sie über eine ständige Wohnstätte verfügt; vergügt sie in beiden Staaten über eine ständige Wohnstätte, so gilt sie als in dem Staat ansässig, zu dem sie die engeren persönlichen und wirtschaftlichen Beziehungen hat (Mittelpunkt der Lebensinteressen);
b) kann nicht bestimmt werden, in welchem Staat die Person den Mittelpunkt ihrer Lebensinteressen hat, oder verfügt sie in keinem der Staaten über eine ständige Wohnstätte, so gilt sie als in dem Staat ansässig, in dem sie ihren gewöhnlichen Aufenthalt hat;
c) hat die Person ihren gewöhnlichen Aufenthalt in beiden Staaten oder in keinem der Staaten, so gilt sie als in dem Staat ansässig, dessen Staatsangehöriger sie ist;
d) ist die Person Staatsangehöriger beider Staaten oder keines der Staaten, so regeln die zuständigen Behörden der Vertragsstaaten die Frage in gegenseitigem Einvernehmen.

(3) Ist nach Absatz 1 eine andere als eine natürliche Person in beiden Vertragsstaaten ansässig, so gilt sie als in dem Staat ansässig, in dem sich der Ort ihrer tatsächlichen Geschäftsleitung befindet.

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* Published by the Bundesminister der Finanzen (Federal Minister of Finance) in his letter of July 1, 1977 IV C 5 - S 1315 — 30/77 directed to the tax administrations in the German "Länder". The International Bureau of Fiscal Documentation gratefully acknowledges the permission to reproduce this text.

1. Schweiz: Statt "Gebietskörperschaften" die Worte "politische Unterabteilungen oder lokale Körperschaften".

**Artikel 5**
*Betriebstätte*

(1) Im Sinne dieses Abkommens bedeutet der Ausdruck "Betriebstätte" eine feste Geschäftseinrichtung, durch die die Tätigkeit eines Unternehmens ganz oder teilweise ausgeübt wird.

(2) Der Ausdruck "Betriebstätte" umfasst insbesondere:
a) einen Ort der Leitung,
b) eine Zweigniederlassung,
c) eine Geschäftsstelle,
d) eine Fabrikationsstätte,
e) eine Werkstätte und
f) ein Bergwerk, ein Öl- oder Gasvorkommen, einen Steinbruck oder eine andere Stätte der Ausbeutung von Bodenschätzen.

(3) Eine Bauausführung oder Montage ist nur dann eine Betriebstätte, wenn ihre Dauer zwölf Monate überschreitet.

(4) Ungeachtet der vorstehenden Bestimmungen dieses Artikels gelten nicht als Betriebstätten:
a) Einrichtungen, die ausschliesslich zur Lagerung, Ausstellung oder Auslieferung von Gütern oder Waren des Unternehmens benutzt werden;
b) Bestände von Gütern oder Waren des Unternehmens, die ausschliesslich zur Lagerung, Ausstellung oder Auslieferung unterhalten werden;
c) Bestände von Gütern oder Waren des Unternehmens, die ausschliesslich zu dem Zweck unterhalten werden, durch ein anderes Unternehmen bearbeitet oder verarbeitet zu werden;
d) eine feste Geschäftseinrichtung, die ausschliesslich zu dem Zweck unterhalten wird, für das Unternehmen Güter oder Waren einzukaufen oder Informationen zu beschaffen;
e) eine feste Geschäftseinrichtung, die ausschliesslich zu dem Zweck unterhalten wird, für das Unternehmen andere Tätigkeiten auszuüben, die vorbereitender Art sind oder eine Hilfstätigkeit darstellen;
f) eine feste Geschäftseinrichtung, die ausschliesslich zu dem Zweck unterhalten wird, mehrere der unter den Buchstaben a bis e genannten Tätigkeiten auszuüben, vorausgesetzt, dass die sich daraus ergebende Gesamttätigkeit der festen Geschäftseinrichtung vorbereitender Art ist oder eine Hilfstätigkeit darstellt.

(5) Ist eine Person — mit Ausnahme eines unabhängigen Vertreters im Sinne des Absatzes 6 — für ein Unternehmen tätig und besitzt sie in einem Vertragsstaat die Vollmacht, im Namen des Unternehmens Verträge abzuschliessen, und übt sie die Vollmacht dort gewöhnlich aus, so wird das Unternehmen ungeachtet der Absätze 1 und 2 so behandelt, als habe es in diesem Staat für alle von der Person für das Unternehmen ausgeübten Tätigkeiten eine Betriebstätte, es sei denn, diese Tätigkeiten beschränken sich auf die in Absatz 4 genannten Tätigkeiten, die, würden sie durch eine feste Geschäftseinrichtung ausgeübt, diese Einrichtung nach dem genannten Absatz nicht zu einer Betriebstätte machten.

(6) Ein Unternehmen wird nicht schon deshalb so behandelt, als habe es eine Betriebstätte in einem Vertragsstaat, weil es dort seine Tätigkeit durch einen Makler, Kommissionär oder einen anderen unabhängigen Vertreter ausübt, sofern diese Personen im Rahmen ihrer ordentlichen Geschäftstätigkeit handeln.

(7) Allein dadurch, dass eine in einem Vertragsstaat ansässige Gesellschaft eine Gesellschaft beherrscht oder von einer Gesellschaft beherrscht wird, die im anderen Vertragsstaat ansässig ist oder dort (entweder durch eine Betriebstätte oder auf andere Weise) ihre Tätigkeit ausübt, wird keine der beiden Gesellschaften zur Betriebstätte der anderen.

## ABSCHNITT III
Besteuerung des Einkommens

**Artikel 6**
*Einkünfte aus unbeweglichem Vermögen*

(1) Einkünfte, die eine in einem Vertragsstaat ansässige Person aus unbeweglichem Vermögen (einschliesslich der Einkünfte aus land- und forstwirtschaftlichen Betrieben) bezieht, das im anderen Vertragsstaat liegt, können [2] im anderen Staat besteuert werden.

(2) Der Ausdruck "unbewegliches Vermögen" hat die Bedeutung, die ihm nach dem Recht des Vertragsstaats zukommt, in dem das Vermögen liegt. Der Ausdruck umfasst in jedem Fall das Zubehör [3] zum unbeweglichen Vermögen, das lebende und tote Inventar land- und forstwirtschaftlicher Betriebe, die Rechte, für die die Vorschriften des Privatrechts über Grundstücke gelten, Nutzungsrechte an unbeweglichem Vermögen sowie Rechte auf veränderliche oder feste Vergütungen für die Ausbeutung oder das Recht auf Ausbeutung von Mineralvorkommen, Quellen und anderen Bodenschätzen; Schiffe und Luftfahrzeuge gelten nicht als unbewegliches Vermögen.

(3) Absatz 1 gilt für Einkünfte aus der unmittelbaren Nutzung, der Vermietung oder Verpachtung sowie jeder anderen Art der Nutzung unbeweglichen Vermögens.

(4) Die Absätze 1 und 3 gelten auch für Einkünfte aus unbeweglichem Vermögen eines Unternehmens und für Einkünfte aus unbeweglichem Vermögen, das der Ausübung einer Selbständigen Arbeit dient.

**Artikel 7**
*Unternehmensgewinne*

(1) Gewinne eines Unternehmens eines Vertragsstaats können [2] nur in diesem Staat besteuert werden, es sei denn, das Unternehmen übt seine Tätigkeit im anderen Vertragsstaat durch eine dort gelegene Betriebstätte aus. Übt das Unternehmen seine Tätigkeit auf diese Weise aus, so können [2] die Gewinne des Unternehmens im anderen Staat besteuert werden, jedoch nur insoweit, als sie dieser Betriebstätte zugerechnet werden können.

(2) Übt ein Unternehmen eines Vertragsstaats seine Tätigkeit im anderen Vertragsstaat durch eine dort gelegene Betriebstätte aus, so werden vorbehaltlich des Absatzes 3 in jedem Vertragsstaat dieser Betriebstätte die Gewinne zugerechnet, die sie hätte erzielen können, wenn sie eine gleiche oder ähnliche Tätigkeit unter gleichen oder ähnlichen Bedingungen als selbständiges Unternehmen ausgeübt hätte und im Verkehr mit dem Unternehmen, dessen Betriebstätte sie ist, völlig unabhängig gewesen wäre.

(3) Bei der Ermittlung der Gewinne einer Betriebstätte werden die für diese Betriebstätte entstandenen Aufwendungen, einschliesslich der Geschäftsführungs- und allgemeinen Verwaltungskosten, zum Abzug zugelassen, gleichgültig, ob sie in dem Staat, in dem die Betriebstätte liegt, oder anderswo entstanden sind.

(4) Soweit es in einem Vertragsstaat üblich ist, die einer Betriebstätte zuzurechnenden Gewinne durch Aufteilung der Gesamtgewinne des Unternehmens auf seine einzelnen Teile zu ermitteln, schliesst Absatz 2 nicht aus, dass dieser Vertragsstaat die zu besteuernden Gewinne nach der üblichen Aufteilung ermittelt; die gewählte Gewinnaufteilung muss jedoch derart sein, dass das Ergebnis mit den Grundsätzen dieses Artikels übereinstimmt.

(5) Auf Grund des blossen Einkaufs von Gütern oder Waren für das Unternehmen wird einer Betriebstätte kein Gewinn zugerechnet.

(6) Bei der Anwendung der vorstehenden Absätze sind die der Betriebstätte zuzurechnenden Gewinne jedes Jahr auf dieselbe Art zu ermitteln, es sei denn, dass ausreichende Gründe dafür bestehen, anders zu verfahren.

(7) Gehören zu den Gewinnen Einkünfte, die in anderen Artikeln dieses Abkommens behandelt werden, so werden die Bestimmungen jener Artikel durch die Bestimmungen dieses Artikels nich berührt.

**Artikel 8**
*Seeschiffahrt, Binnenschiffahrt und Luftfahrt*

(1) Gewinne aus dem Betrieb von Seeschiffen oder Luftfahrzeugen im internationalen Verkehr können [2] nur in dem Vertragsstaat besteuert werden, in dem sich der Ort der tatsächlichen Geschäftsleitung des Unternehmens befindet.

(2) Gewinne aus dem Betrieb von Schiffen, die der Binnenschiffahrt dienen, können [2] nur in dem Vertragsstaat besteuert werden, in dem sich der Ort der tatsächlichen Geschäftsleitung des Unternehmens befindet.

(3) Befindet sich der Ort der tatsächlichen Geschäftsleitung eines Unternehmens der See- oder Binnenschiffahrt an Bord eines Schiffes, so gilt er als in dem Vertragsstaat gelegen, in dem der Heimathafen des Schiffes liegt, oder, wenn kein Heimathafen vorhanden ist, in dem Vertragsstaat, in dem die Person ansässig ist, die das Schiff betreibt.

(4) Absatz 1 gilt auch für Gewinne aus der Beteiligung an einem Pool, einer Betriebsgemeinschaft oder einer internationalen Betriebsstelle.

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2. Österreich: Statt "können" oder "kann" die Worte "dürfen" oder "darf".
3. Schweiz: Statt "das Zubehör" die Worte "die Zugehör".

**Artikel 9**
*Verbundene Unternehmen*

(1) Wenn
a) ein Unternehmen eines Vertragsstaats unmittelbar oder mittelbar an der Geschäftsleitung, der Kontrolle oder dem Kapital eines Unternehmens des anderen Vertragsstaats beteiligt ist oder
b) dieselben Personen unmittelbar oder mittelbar an der Geschäftsleitung, der Kontrolle oder dem Kapital eines Unternehmens eines Vertragsstaats und eines Unternehmens des anderen Vertragsstaats beteiligt sind

und in diesen Fällen die beiden Unternehmen in ihren kaufmännischen oder finanziellen Beziehungen an vereinbarte oder auferlegte Bedingungen gebunden sind, die von denen abweichen, die unabhängige Unternehmen miteinander vereinbaren würden, so dürfen die Gewinne, die eines der Unternehmen ohne diese Bedingungen erzielt hätte, wegen dieser Bedingungen aber nicht erzielt hat, den Gewinnen dieses Unternehmens zugerechnet und entsprechend besteuert werden.

(2) Werden in einem Vertragsstaat den Gewinnen eines Unternehmens dieses Staates Gewinne zugerechnet — und entsprechend besteuert —, mit denen ein Unternehmen des anderen Vertragsstaats in diesem Staat besteuert worden ist, und handelt es sich bei den zugerechneten Gewinnen um solche, die das Unternehmen des erstgenannten Staates erzielt hätte, wenn die zwischen den beiden Unternehmen vereinbarten Bedingungen die gleichen gewesen wären, die unabhängige Unternehmen miteinander vereinbaren würden, so nimmt der andere Staat eine entsprechende Änderung der dort von diesen Gewinnen erhobenen Steuer vor. Bei dieser Änderung sind die übrigen Bestimmungen dieses Abkommens zu berücksichtigen; erforderlichenfalls werden die zuständigen Behörden der Vertragsstaaten einander konsultieren.

**Artikel 10**
*Dividenden*

(1) Dividenden, die eine in einem Vertragsstaat ansässige Gesellschaft an eine im anderen Vertragsstaat ansässige Person zahlt, können [2] im anderen Staat besteuert werden.

(2) Diese Dividenden können [2] jedoch auch in dem Vertragsstaat, in dem die die Dividenden zahlende Gesellschaft ansässig ist, nach dem Recht dieses Staates besteuert werden; die Steuer darf aber, wenn der Empfänger der Dividenden der Nutzungsberechtigte ist, nich übersteigen:
a) 5 vom Hundert des Bruttobetrags der Dividenden, wenn der Nutzungsberechtigte eine Gesellschaft (jedoch keine Personengesellschaft) ist, die unmittelbar über mindestens 25 vom Hundert des Kapitals der die Dividenden zahlenden Gesellschaft verfügt;
b) 15 vom Hundert des Bruttobetrags der Dividenden in allen anderen Fällen.

Die zuständigen Behörden der Vertragsstaaten regeln in gegenseitigem Einvernehmen, wie diese Begrenzungsbestimmungen durchzuführen sind.

Dieser Absatz berührt nicht die Besteuerung der Gesellschaft in bezug auf die Gewinne, aus denen die Dividenden gezahlt werden.

(3) Der in diesem Artikel verwendete Ausdruck "Dividenden" bedeutet Einkünfte aus Aktien, Genussaktien [4] oder Genussscheinen, Kuxen, Gründeranteilen oder anderen Rechten — ausgenommen Forderungen — mit Gewinnbeteiligung sowie aus sonstigen Gesellschaftsanteilen stammende Einkünfte, die nach dem Recht des Staates, in dem die ausschüttende Gesellschaft ansässig ist, den Einkünften aus Aktien steuerlich gleichgestellt sind.

(4) Die Absätze 1 und 2 sind nicht anzuwenden, wenn der in einem Vertragsstaat ansässige Nutzungsberechtigte im anderen Vertragsstaat, in dem die die Dividenden zahlende Gesellschaft ansässig ist, eine gewerbliche Tätigkeit durch eine dort gelegene Betriebstätte oder eine selbständige Arbeit durch eine dort gelegene feste Einrichtung ausübt und die Beteiligung, für die die Dividenden gezahlt werden, tatsächlich zu dieser Betriebstätte oder festen Einrichtung gehört. In diesem Fall ist Artikel 7 beziehungsweise Artikel 14 anzuwenden.

(5) Bezieht eine in einem Vertragsstaat ansässige Gesellschaft Gewinne oder Einkünfte aus dem anderen Vertragsstaat, so darf dieser andere Staat weder die von der Gesellschaft gezahlten Dividenden besteuern, es sei denn, dass diese Dividenden an eine im anderen Staat ansässige Person gezahlt werden oder dass die Beteiligung, für die die Dividenden gezahlt werden, tatsächlich zu einer im anderen Staat gelegenen Betriebstätte oder festen Einrichtung gehört, noch Gewinne der Gesellschaft einer Steuer für nichtausgeschüttete Gewinne unterwerfen, selbst wenn die gezahlten Dividenden oder die nichtausgeschütteten Gewinne ganz oder teilweise aus im anderen Staat erzielten Gewinnen oder Einkünften bestehen.

**Artikel 11**
*Zinsen*

(1) Zinsen, die aus einem Vertragsstaat stammen und an eine im anderen Vertragsstaat ansässige Person gezahlt werden, können [2] im anderen Staat besteuert werden.

(2) Diese Zinsen können [2] jedoch auch in dem Vertragsstaat, aus dem sie stammen, nach dem Recht dieses Staates besteuert werden; die Steuer darf aber, wenn der Empfänger der Zinsen der Nutzungsberechtigte ist, 10 vom Hundert des Bruttobetrags der Zinsen nicht übersteigen. Die zuständigen Behörden der Vertragsstaaten regeln in gegenseitigem Einvernehmen, wie diese Begrenzungsbestimmung durchzuführen ist.

(3) Der in diesem Artikel verwendete Ausdruck "Zinsen" bedeutet Einkünfte aus Forderungen jeder Art, auch wenn die Forderungen durch Pfandrechte an Grundstücken gesichert oder mit einer Beteiligung am Gewinn des Schuldners ausgestattet sind, und insbesondere Einkünfte aus öffentlichen Anleihen und aus Obligationen einschliesslich der damit verbundenen Aufgelder und der Gewinne aus Losanleihen. Zuschläge für verspätete Zahlung gelten nicht als Zinsen im Sinne dieses Artikels.

(4) Die Absätze 1 und 2 sind nicht anzuwenden, wenn der in einem Vertragsstaat ansässige Nutzungsberechtigte im anderen Vertragsstaat, aus dem die Zinsen stammen, eine gewerbliche Tätigkeit durch eine dort gelegene Betriebstätte oder eine selbständige Arbeit durch eine dort gelegene feste Einrichtung ausübt und die Forderung, für die die Zinsen gezahlt werden, tatsächlich zu dieser Betriebstätte oder festen Einrichtung gehört. In diesem Fall ist Artikel 7 beziehungsweise Artikel 14 anzuwenden.

(5) Zinsen gelten dann als aus einem Vertragsstaat stammend, wenn der Schuldner dieser Staat selbst, eine seiner Gebietskörperschaften [1] oder eine in diesem Staat ansässige Person ist. Hat aber der Schuldner der Zinsen, ohne Rücksicht darauf, ob er in einem Vertragsstaat ansässig ist oder nicht, in einem Vertragsstaat eine Betriebstätte oder eine feste Einrichtung und ist die Schuld, für die die Zinsen gezahlt werden, für Zwecke der Betriebstätte oder der festen Einrichtung eingegangen worden und trägt die Betriebstätte oder die feste Einrichtung die Zinsen, so gelten die Zinsen als aus dem Staat stammend, in dem die Betriebstätte oder die feste Einrichtung liegt.

(6) Bestehen zwischen dem Schuldner und dem Nutzungsberechtigten oder zwischen jedem von ihnen und einem Dritten besondere Beziehungen und übersteigen deshalb die Zinsen, gemessen an der zugrundeliegenden Forderung, den Betrag, den Schuldner und Nutzungsberechtigter ohne diese Beziehungen vereinbart hätten, so wird dieser Artikel nur auf den letzteren Betrag angewendet. In diesem Fall kann der übersteigende Betrag nach dem Recht eines jeden Vertragsstaats und unter Berücksichtigung der anderen Bestimmungen dieses Abkommens besteuert werden.

**Artikel 12**
*Lizenzgebühren*

(1) Lizenzgebühren, die aus einem Vertragsstaat stammen und an eine im anderen Vertragsstaat ansässige Person gezahlt werden, können, [2] wenn diese Person der Nutzungsberechtigte ist, nur im anderen Staat besteuert werden.

(2) Der in diesem Artikel verwendete Ausdruck "Lizenzgebühren" bedeutet Vergütungen jeder Art, die für die Benutzung oder für das Recht auf Benutzung von Urheberrechten an literarischen, künstlerischen oder wissenschaftlichen Werken, einschliesslich kinematographischer Filme, von Patenten, Marken, [5] Mustern oder Modellen, Plänen, geheimen Formeln oder Verfahren oder für die Benutzung oder das

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1. Schweiz: Statt "Gebietskörperschaften" die Worte "politische Unterabteilungen oder lokale Körperschaften".
2. Österreich: Statt "können" oder "kann" die Worte "dürfen" oder "darf".
4. Bundesrepublik Deutschland: Statt "Genussaktien" das Wort "Genussrechten".
5. Bundesrepublik Deutschland: Statt "Marken" das Wort "Warenzeichen".

Recht auf Benutzung gewerblicher, kaufmännischer oder wissenschaftlicher Ausrüstungen oder für die Mitteilung gewerblicher, kaufmännischer oder wissenschaftlicher Erfahrungen gezahlt werden.

(3) Absatz 1 ist nicht anzuwenden, wenn der in einem Vertragsstaat ansässige Nutzungsberechtigte im anderen Vertragsstaat, aus dem die Lizenzgebühren stammen, eine gewerbliche Tätigkeit durch eine dort gelegene Betriebstätte oder eine selbständige Arbeit durch eine dort gelegene feste Einrichtung ausübt und die Rechte oder Vermögenswerte, für die die Lizenzgebühren gezahlt werden, tatsächlich zu dieser Betriebstätte oder festen Einrichtung gehören. In diesem Fall ist Artikel 7 beziehungsweise Artikel 14 anzuwenden.

(4) Bestehen zwischen dem Schuldner und dem Nutzungsberechtigten oder zwischen jedem von ihnen und einem Dritten besondere Beziehungen und übersteigen deshalb die Lizenzgebühren, gemessen an der zugrundeliegenden Leistung, den Betrag, den Schuldner und Nutzungsberechtigter ohne diese Beziehungen vereinbart hätten, so wird dieser Artikel nur auf den letzteren Betrag angewendet. In diesem Fall kann der übersteigende Betrag nach dem Recht eines jeden Vertragsstaats und unter Berücksichtigung der anderen Bestimmungen dieses Abkommens besteuert werden.

**Artikel 13**
*Gewinne aus der Veräusserung von Vermögen*

(1) Gewinne, die eine in einem Vertragsstaat ansässige Person aus der Veräusserung unbeweglichen Vermögens im Sinne des Artikels 6 bezieht, das im anderen Vertragsstaat liegt, können [2] im anderen Staat besteuert werden.

(2) Gewinne aus der Veräusserung beweglichen Vermögens, das Betriebsvermögen einer Betriebstätte ist, die ein Unternehmen eines Vertragsstaats im anderen Vertragsstaat hat, oder das zu einer festen Einrichtung gehört, die einer in einem Vertragsstaat ansässigen Person für die Ausübung einer selbständigen Arbeit im anderen Vertragsstaat zur Verfügung steht, einschliesslich derartiger Gewinne, die bei der Veräusserung einer solchen Betriebstätte (allein oder mit dem übrigen Unternehmen) oder einer solchen feste Einrichtung erzielt werden, können [2] im anderen Staat besteuert werden.

(3) Gewinne aus der Veräusserung von Seeschiffen oder Luftfahrzeugen, die im internationalen Verkehr betrieben werden, von Schiffen, die der Binnenschiffahrt dienen, und von beweglichem Vermögen, das dem Betrieb dieser Schiffe oder Luftfahrzeuge dient, können [2] nur in dem Vertragsstaat besteuert werden, in dem sich der Ort der tatsächlichen Geschäftsleitung des Unternehmens befindet.

(4) Gewinne aus der Veräusserung des in den Absätzen 1, 2 und 3 nicht genannten Vermögens können [2] nur in dem Vertragsstaat besteuert werden, in dem der Veräusserer ansässig ist.

**Artikel 14**
*Selbständige Arbeit*

(1) Einkünfte, die eine in einem Vertragsstaat ansässige Person aus einem freien Beruf oder aus sonstiger selbständiger Tätigkeit bezieht, können [2] nur in diesem Staat besteuert werden, es sei denn, dass der Person im anderen Vertragsstaat für die Ausübung ihrer Tätigkeit gewöhnlich eine feste Einrichtung zur Verfügung steht. Steht ihr eine solche feste Einrichtung zur Verfügung so können [2] die Einkünfte im anderen Staat besteuert werden, jedoch nur insoweit, als sie dieser festen Einrichtung zugerechnet werden können.

(2) Der Ausdruck "freier Beruf" umfasst insbesondere die selbständig ausgeübte wissenschaftliche, literarische, künstlerische, erzieherische oder unterrichtende Tätigkeit sowie die selbständige Tätigkeit der Ärzte, Rechtsanwälte, Ingenieure, Architekten, Zahnärzte und Buchsachverständigen.

**Artikel 15**
*Unselbständige Arbeit*

(1) Vorbehaltlich der Artikel 16, 18 und 19 können [2] Gehälter, Löhne und ähnliche Vergütungen, die eine in einem Vertragsstaat ansässige Person aus unselbständiger Arbeit bezieht, nur in diesem Staat besteuert werden, es sei denn, die Arbeit wird im anderen Vertragsstaat ausgeübt. Wird die Arbeit dort ausgeübt, so können [2] die dafür bezogenen Vergütungen im anderen Staat besteuert werden.

(2) Ungeachtet des Absatzes 1 können [2] Vergütungen, die eine in einem Vertragsstaat ansässige Person für eine im anderen Vertragsstaat ausgeübte unselbständige Arbeit bezieht, nur im erstgenannten Staat besteuert werden, wenn
a) der Empfänger sich im anderen Staat insgesamt nicht länger als 183 Tage während des betreffenden Steuerjahres aufhält und
b) die Vergütungen von einem Arbeitgeber oder für einen Arbeitgeber gezahlt werden, der nicht im anderen Staat ansässig ist, und
c) die Vergütungen nicht von einer Betriebstätte oder einer festen Einrichtung getragen werden, die der Arbeitgeber im anderen Staat hat.

(3) Ungeachtet der vorstehenden Bestimmungen dieses Artikels können [2] Vergütungen für unselbständige Arbeit, die an Bord eines Seeschiffes oder Luftfahrzeuges, das im internationalen Verkehr betrieben wird, oder an Bord eines Schiffes, das der Binnenschiffahrt dient, ausgeübt wird, in dem Vertragsstaat besteuert werden, in dem sich der Ort der tatsächlichen Geschäftsleitung des Unternehmens befindet.

**Artikel 16**
*Aufsichtsrats- und Verwaltungsratsvergütungen*

Aufsichtsrats- oder Verwaltungsratsvergütungen und ähnliche Zahlungen, die eine in einem Vertragsstaat ansässige Person in ihrer Eigenschaft als Mitglied des Aufsichts- oder Verwaltungsrats einer Gesellschaft bezieht, die im anderen Vertragsstaat ansässig ist, können [2] im anderen Staat besteuert werden.

**Artikel 17**
*Künstler under Sportler*

(1) Ungeachtet der Artikel 14 und 15 können [2] Einkünfte, die eine in einem Vertragsstaat ansässige Person als Künstler, wie Bühnen-, Film-, Rundfunk- und Fernsehkünstler sowie Musiker, oder als Sportler aus ihrer im anderen Vertragsstaat persönlich ausgeübten Tätigkeit bezieht, im anderen Staat besteuert werden.

(2) Fliessen Einkünfte aus einer von einem Künstler oder Sportler in dieser Eigenschaft persönlich ausgeübten Tätigkeit nicht dem Künstler oder Sportler selbst, sondern einen anderen Person zu, so können [2] diese Einkünfte ungeachtet der Artikel 7, 14 und 15 in dem Vertragsstaat besteuert werden, in dem der Künstler oder Sportler seine Tätigkeit ausübt.

**Artikel 18**
*Ruhegehälter*

Vorbehaltlich des Artikels 19 Absatz 2 können [2] Ruhegehälter und ähnliche Vergütungen, die einer in einem Vertragsstaat ansässigen Person für frühere unselbständige Arbeit gezahlt werden, nur in diesem Staat besteuert werden.

**Artikel 19**
*Offentlicher Dienst*

(1) a) Vergütungen, ausgenommen Ruhegehälter, die von einem Vertragsstaat oder einer seiner Gebietskörperschaften [1] an eine natürliche Person für die diesem Staat oder der Gebietskörperschaft [1] geleisteten Dienste gezahlt werden, können [2] nur in diesem Staat besteuert werden.
b) Diese Vergütungen können [2] jedoch nur im anderen Vertragsstaat besteuert werden, wenn die Dienste in diesem Staat geleistet werden und die natürliche Person in diesem Staat ansässig ist und
i) ein Staatsangehöriger dieses Staates ist oder
ii) nicht ausschliesslich deshalb in diesem Staat ansässig geworden ist, um die Dienste zu leisten.

(2) a) Ruhegehälter, die von einem Vertragsstaat oder einer seiner Gebietskörperschaften [1] oder aus einem von diesem Staat oder der Gebietskörperschaft [1] errichteten Sondervermögen an eine natürliche Person für die diesem Staat oder der Gebietskörperschaft [1] geleisteten Dienste gezahlt werden, können [2] nur in diesem Staat besteuert werden.
b) Diese Ruhegehälter können [2] jedoch nur im anderen Vertragsstaat besteuert werden, wenn die natürliche Person in diesem Staat ansässig ist und ein Staatsangehöriger dieses Staates ist.

1. Schweiz: Statt "Gebietskörperschaften" die Worte "politische Unterabteilungen oder lokale Körperschaften".
2. Österreich: Statt "können" oder "kann" die Worte "dürfen" oder "darf".

(3) Auf Vergütungen und Ruhegehälter für Dienstleistungen, die im Zusammenhang mit einer gewerblichen Tätigkeit eines Vertragsstaats oder einer seiner Gebietskörperschaften [1] erbracht werden, sind die Artikel 15, 16 und 18 anzuwenden.

### Artikel 20
*Studenten*

Zahlungen, die ein Student, Praktikant oder Lehrling, der sich in einem Vertragsstaat ausschliesslich zum Studium oder zur Ausbildung aufhält und der im anderen Vertragsstaat ansässig ist oder dort unmittelbar vor der Einreise in den erstgenannten Staat ansässig war, für seinen Unterhalt, sein Studium oder seine Ausbildung erhält, dürfen im erstgenannten Staat nicht besteuert werden, sofern diese Zahlungen aus Quellen ausserhalb dieses Staates stammen.

### Artikel 21
*Andere Einkünfte*

(1) Einkünfte einer in einem Vertragsstaat ansässigen Person, die in den vorstehenden Artikeln nicht behandelt wurden, können [2] ohne Rücksicht auf ihre Herkunft nur in diesem Staat besteuert werden.

(2) Absatz 1 ist auf andere Einkünfte als solche aus unbeweglichem Vermögen im Sinne des Artikels 6 Absatz 2 nicht anzuwenden, wenn der in einem Vertragsstaat ansässige Empfänger im anderen Vertragsstaat eine gewerbliche Tätigkeit durch eine dort gelegene Betriebstätte oder eine selbständige Arbeit durch eine dort gelegene feste Einrichtung ausübt und die Rechte oder Vermögenswerte, für die die Einküngte gezahlt werden, tatsächlich zu dieser Betriebstätte oder festen Einrichtung gehören. In diesem Fall ist Artikel 7 beziehungsweise Artikel 14 anzuwenden.

## ABSCHNITT IV
Besteuerung des Vermögens

### Artikel 22
*Vermögen*

(1) Unbewegliches Vermögen im Sinne des Artikels 6, das einer in einem Vertragsstaat ansässigen Person gehört und im anderen Vertragsstaat liegt, kann [2] im anderen Staat besteuert werden.

(2) Bewegliches Vermögen, das Betriebsvermögen einer Betriebstätte ist, die ein Undernehmen eines Vertragsstaats im anderen Vertragsstaat hat, oder das zu einer festen Einrichtung gehört, die einer in einem Vertragsstaat ansässigen Person für die Ausübung einer selbständigen Arbeit im anderen Vertragsstaat zur Verfügung steht, kann [2] im anderen Staat besteuert werden.

(3) Seeschiffe und Luftfahrzeuge, die im internationalen Verkehr betrieben werden, und Schiffe, die der Binnenschiffahrt dienen, sowie bewegliches Vermögen, das dam Betrieb dieser Schiffe oder Luftfahrzeuge dient, können [2] nur in dem Vertragsstaat besteuert werden, in dem sich der Ort der tatsächlichen Geschäftsleitung des Unternehmens befindet.

(4) Alle anderen Vermögensteile einer in einem Vertragsstaat ansässigen Person können [2] nur in diesem Staat besteuert werden,

## ABSCHNITT V
Methoden zur Vermeidung der Doppelbesteuerung

### Artikel 23A
*Befreiungsmethode*

(1) Bezieht eine in einem Vertragsstaat ansässige Person Einkünfte oder hat sie Vermögen und können [2] diese Einkünfte oder dieses Vermögen nach diesem Abkommen im anderen Vertragsstaat besteuert werden, so nimmt der erstgenannte Staat vorbehaltlich der Absätze 2 und 3 diese Einkünfte oder dieses Vermögen von der Besteuerung aus.

(2) Bezieht eine in einem Vertragsstaat ansässige Person Einkünfte, die nach den Artikeln 10 und 11 im anderen Vertragsstaat besteuert werden können, [2] so rechnet der erstgenannte Staat auf die vom Einkommen dieser Person zu erhebende Steuer den Betrag an, der der im anderen Staat gezahlten Steuer entspricht. Der anzurechnende Betrag darf jedoch den Teil der vor der Anrechnung ermittelten Steuer nicht übersteigen, der auf die aus dem anderen Staat bezogenen Einkünfte entfällt.

(3) Einkünfte oder Vermögen einer in einem Vertragsstaat ansässigen Person, die nach dem Abkommen von der Besteuerung in diesem Staat auszunehmen sind, können [2] gleichwohl in diesem Staat bei der Festsetzung der Steuer für das übrige Einkommen oder Vermögen der Person einbezogen werden.

### Artikel 23B
*Anrechnungsmethode*

(1) Bezieht eine in einem Vertragsstaat ansässige Person Einkünfte oder hat sie Vermögen und können [2] diese Einkünfte oder dieses Vermögen nach diesem Abkommen im anderen Vertragsstaat besteuert werden, so rechnet der erstgenannte Staat
a) auf die vom Einkommen dieser Person zu erhebende Steuer den Betrag an, der der im anderen Staat gezahlten Steuer vom Einkommen entspricht;
b) auf die vom Vermögen dieser Person zu erhebende Steuer den Betrag an, der der im anderen Staat gezahlten Steuer vom Vermögen entspricht.
Der anzurechnende Betrag darf jedoch in beiden Fällen den Teil der vor der Anrechnung ermittelten Steuer vom Einkommen oder vom Vermögen nicht übersteigen, der auf die Einkünfte, die im anderen Staat besteuert werden können, [2] oder auf das Vermögen, das dort besteuert werden kann, [2] entfällt.

(2) Einkünfte oder Vermögen einer in einem Vertragsstaat ansässigen Person, die nach dem Abkommen von der Besteuerung in diesem Staat auszunehmen sind, können [2] gleichwohl in diesem Staat bei der Festsetzung der Steuer für das übrige Einkommen oder Vermögen der Person einbezogen werden.

## ABSCHNITT VI
Besondere Bestimmungen

### Artikel 24
*Gleichbehandlung*

(1) Staatsangehörige eines Vertragsstaats dürfen im anderen Vertragsstaat keiner Besteuerung oder damit zusammenhängenden Verpflichtung unterworfen werden, die anders oder belastender ist als die Besteuerung und die damit zusammenhängenden Verpflichtungen, denen Staatsangehörige des anderen Staates unter gleichen Verhältnissen unterworfen sind oder unterworfen werden können. Diese Bestimmung gilt ungeachtet des Artikels 1 auch für Personen, die in keinem Vertragsstaat ansässig sind.

(2) Der Ausdruck "Staatsangehörige" bedeutet
a) natürliche Personen, die die Staatsangehörigkeit eines Vertragsstaats besitzen;
b) juristische Personen, Personengesellschaften und andere Personenvereinigungen, die nach dem in einem Vertragsstaat geltenden Recht errichtet worden sind.

(3) Staatenlose, die in einem Vertragsstaat ansässig sind, dürfen in keinem Vertragsstaat einer Besteuerung oder damit zusammenhängenden Verpflichtung unterworfen werden, die anders oder belastender ist als die Besteuerung und die damit zusammenhängenden Verpflichtungen, denen Staatsangehörige des betreffenden Staates unter gleichen Verhältnissen unterworfen sind oder unterworfen werden können.

(4) Die Besteuerung einer Betriebstätte, die ein Unternehmen eines Vertragsstaats im anderen Vertragsstaat hat, darf im anderen Staat nicht ungünstiger sein als die Besteuerung von Unternehmen des anderen Staates, die die gleiche Tätigkeit ausüben. Diese Bestimmung ist nicht so auszulegen, als verpflichte sie einen Vertragsstaat, den im anderen Vertragsstaat ansässigen Personen Steuerfreibeträge, -vergünstigungen und -ermässigungen auf Grund des Personenstandes oder der Familienlasten zu gewähren, die er seinen ansässigen Personen gewährt.

(5) Sofern nicht Artikel 9 Absatz 1, Artikel 11 Absatz 6 oder Artikel 12 Absatz 4 anzuwenden ist, sind Zinsen, Lizenzgebühren und andere Entgelte, die ein Unternehmen eines Vertragsstaats an eine im anderen Vertragsstaat ansässige Person zahlt, bei der Ermittlung der steuerpflichtigen Gewinne dieses Unternehmens unter den gleichen Bedingungen wie Zahlungen an eine im erstgenannten Staat ansässige Person zum Abzug zuzulassen. Dementsprechend sind Schulden, die ein Unternehmen eines Vertragsstaats gegenüber einer im anderen Vertragsstaat ansässigen Person hat, bei der Ermittlung des steuerpflichtigen Vermögens dieses Unternehmens unter den gleichen Bedingungen wie Schulden gegenüber einer im erstgenannten Staat ansässigen Person zum Abzug zuzulassen.

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1. Schweiz: Statt "Gebietskörperschaften" die Worte "politische Unterabteilungen oder lokale Körperschaften".
2. Österreich: Statt "können" oder "kann" die Worte "dürfen" oder "darf".

(6) Unternehmen eines Vertragsstaats, deren Kapital ganz oder teilweise unmittelbar oder mittelbar einer im anderen Vertragsstaat ansässigen Person oder mehreren solchen Personen gehört oder ihrer Kontrolle unterliegt, dürfen im erstgenannten Staat keiner Besteuerung oder damit zusammenhängenden Verpflichtung unterworfen werden, die anders oder belastender ist als die Besteuerung und die damit zusammenhängenden Verpflichtungen, denen andere ähnliche Unternehmen des erstgenannten Staates unterworfen sind oder unterworfen werden können.

(7) Dieser Artikel gilt ungeachtet des Artikels 2 für Steuern jeder Art und Bezeichnung.

### Artikel 25
*Verständigungsverfahren*

(1) Ist eine Person der Auffassung, dass Massnahmen eines Vertragsstaats oder beider Vertragsstaaten für sie zu einer Besteuerung führen oder führen werden, die diesem Abkommen nicht entspricht, so kann sie unbeschadet der nach dem innerstaatlichen Recht dieser Staaten vorgesehenen Rechtsmittel ihren Fall der zuständigen Behörde des Vertragsstaats, in dem sie ansässig ist, oder, sofern ihr Fall von Artikel 24 Absatz 1 erfasst wird, der zuständigen Behörde des Vertragsstaats unterbreiten, dessen Staatsangehöriger sie ist. Der Fall muss innerhalb von drei Jahren nach der ersten Mitteilung der Massnahme unterbreitet werden, die zu einer dem Abkommen nicht entsprechenden Besteuerung führt.

(2) Hält die zuständige Behörde die Einwendung für begründet und ist sie selbst nicht in der Lage, eine befriedigende Lösung herbeizuführen, so wird sie sich bemühen, den Fall durch Verständigung mit der zuständigen Behörde des anderen Vertragsstaats so zu regeln, dass eine dem Abkommen nicht entsprechende Besteuerung vermieden wird. Die Verständigungsregelung ist ungeachtet der Fristen des innerstaatlichen Rechts der Vertragsstaaten durchzuführen.

(3) Die zuständigen Behörden der Vertragsstaaten werden sich bemühen, Schwierigkeiten oder Zweifel, die bei der Auslegung oder Anwendung des Abkommens entstehen, in gegenseitigem Einvernehmen zu beseitigen. Sie können auch gemeinsam darüber beraten, wie eine Doppelbesteuerung in Fällen vermieden werden kann, die im Abkommen nicht behandelt sind.

(4) Die zuständigen Behörden der Vertragsstaaten können zur Herbeiführung einer Einigung im Sinne der vorstehenden Absätze unmittelbar miteinander verkehren. Erscheint ein mündlicher Meinungsaustausch für die Herbeiführung der Einigung zweckmässig, so kann ein solcher Meinungsaustausch in einer Kommission durchgeführt werden, die aus Vertretern der zuständigen Behörden der Vertragsstaaten besteht.

### Artikel 26
*Informationsaustausch*

(1) Die zuständigen Behörden der Vertragsstaaten tauschen die Informationen aus, die zur Durchführung dieses Abkommens oder des innerstaatlichen Rechts der Vertragsstaaten betreffend die unter das Abkommen fallenden Steuern erforderlich sind, soweit die diesem Recht entprechende Besteuerung nicht dem Abkommen widerspricht. Der Informationsaustausch ist durch Artikel 1 nicht eingeschränkt. Alle Informationen, die ein Vertragsstaat erhalten hat, sind ebenso geheimzuhalten wie die auf Grund des innerstaatlichen Rechts dieses Staates beschafften Informationen und dürfen nur den Personen oder Behörden (einschliesslich der Gerichte und der Verwaltungsbehörden) zugänglich gemacht werden, die mit der Veranlagung oder Erhebung, der Vollstreckung oder Strafverfolgung oder mit der Entscheidung von Rechtsmitteln hinsichtlich der unter das Abkommen fallenden Steuern befasst sind. Diese Personen oder Behörden dürfen die Informationen nur für diese Zwecke verwenden. Sie dürfen die Informationen in einem öffentlichen Gerichtsverfahren oder in einer Gerichtsentscheidung offenlegen.

(2) Absatz 1 ist nicht so auszulegen, als verpflichte er einen Vertragsstaat,
a) Verwaltungsmassnahmen durchzuführen, die von den Gesetzen und der Verwaltungspraxis dieses oder des anderen Vertragsstaats abweichen;
b) Informationen zu erteilen, die nach den Gesetzen oder im üblichen Verwaltungsverfahren dieses oder des anderen Vertragsstaats nicht beschafft werden können;
c) Informationen zu erteilen, die ein Handels-, Industrie-, Gewerbe- oder Berufsgeheimnis oder ein Geschäftsverfahren preisgeben würden oder deren Erteilung dem Ordre Public [6] widerspräche.

### Artikel 27
*Diplomaten und Konsularbeamte*

Dieses Abkommen berührt nicht die steuerlichen Vorrechte, die den Diplomaten und Konsularbeamten nach den allgemeinen Regeln des Völkerrechts oder auf Grund besonderer Übereinkünfte zustehen.

### Artikel 28
*Ausdehnung [7] des räumlichen Geltungsbereichs*

(1) Dieses Abkommen kann entweder als Ganzes oder mit den erforderlichen Änderungen [auf jeden Teil des Hoheitsgebiets (des Staates A) oder (des Staates B), der ausdrücklich von der Anwendung des Abkommens ausgeschlossen ist, oder] auf jeden anderen Staat oder jedes andere Hoheitsgebiet ausgedehnt [8] werden, dessen internationale Beziehungen von (Staat A) oder von (Staat B) wahrgenommen werden und in dem Steuern erhoben werden, die im wesentlichen den Steuern ähnlich sind, für die das Abkommen gilt. Eine solche Ausdehnung [7] wird von dem Zeitpunkt an und mit den Änderungen und Bedingungen, einschliesslich der Bedingungen für die Beendigung, wirksam, die zwischen den Vertragsstaaten durch auf diplomatischem Weg auszutauschende Noten oder auf andere, den Verfassungen dieser Staaten entsprechende Weise vereinbart werden.

(2) Haben die beiden Vertragsstaaten nichts anderes vereinbart, so wird mit der Kündigung durch einen Vertragsstaat nach Artikel 30 die Anwendung des Abkommens in der in jenem Artikel vorgesehenen Weise auch [für jeden Teil des Hoheitsgebiets (des Staates A) oder (des Staates B) oder] für Staaten oder Hoheitsgebiete beendet, auf die das Abkommen nach diesem Artikel ausgedehnt [8] worden ist.

*Anmerkung:*
Die Worte in eckigen Klammern gelten, wenn das Abkommen auf Grund einer besonderen Bestimmung für einen Teil des Hoheitsgebiets eines Vertragsstaats nicht anzuwenden ist.

## ABSCHNITT VII
Schlussbestimmungen

### Artikel 29
*Inkrafttreten*

(1) Dieses Abkommen bedarf der Ratifikation; die Ratifikationsurkunden werden so bald wie möglich in ... ausgetauscht.

(2) Das Abkommen tritt mit dem Austausch der Ratifikationsurkunden in Kraft, und seine Bestimmungen finden Anwendung
a) (in Staat A): ...
b) (in Staat B): ...

### Artikel 30
*Kündigung*

Dieses Abkommen bleibt in Kraft, solange es nicht von einem Vertragsstaat gekündigt wird. Jeder Vertragsstaat kann nach dem Jahr ... das Abkommen auf diplomatischem Weg unter Einhaltung einer Frist von mindestens sechs Monaten zum Ende eines Kalenderjahres kündigen. In diesem Fall findet das Abkommen nicht mehr Anwendung
a) (in Staat A): ...
b) (in Staat B): ...

## SCHLUSSKLAUSEL

*Anmerkung:*
Die Schlussklausel über die Unterzeichnung richtet sich nach den verfassungsrechtlichen Verfahren der beiden Vertragsstaaten.

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6. Bundesrepublik Deutschland: Statt "dem Ordre public" die Worte "der öffentlichen Ordnung".
7. Bundesrepublik Deutschland: Statt "Ausdehnung" das Wort "Erstreckung".
8. Bundesrepublik Deutschland: Statt "ausgedehnt" das Wort "erstreckt".

# LIST OF TAX TREATIES

## CONCLUDED BY

# THAILAND

**Concerning comprehensive double taxation treaties on income/capital**

**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Denmark | income, capital | April 14, 1965 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 128<br>Treaty Series, Vol. 551, p. 158 |
| France | income | December 27, 1974 | French and Thai | AP treaties<br>SUPP SER. Section C |
| German Federal Republic | income, capital | July 10, 1967 | English, German and Thai | AP treaties<br>SUPP. SER. Section C |
| Japan | income | March 1, 1963 | English | AP treaties |
| Netherlands | income, capital | September 11, 1975 | English, Dutch and Thai | AP treaties<br>SUPP. SER. Section C |
| Norway | income, capital | January 9, 1964 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 120<br>Treaty Series, Vol. 522, p. 66 |
| Singapore | income | September 15, 1975 | English | AP treaties<br>BULL Supplement E (1976)<br>IX UN A(1) 364 |
| Sweden | income, capital | October 20, 1961 | English | AP treaties<br>SUPP. SER. Section C |

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation).
SUPP. SER. Section C = Supplementary Service to European Taxation, Section C.
BULL = Bulletin for International Fiscal Documentation.
Treaty Series = Treaties and international agreements registered or filed and recorded with the Secretariat of the United Nations. In addition to the official text of each agreement, this publication produces a translation in either English or French as the case may be.
UN = United Nations. Department of Economic and Social Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes.

## CONCLUDED BY

# MALAYSIA

**Concerning comprehensive double taxation treaties on income/capital**

**The list is up to date as of March 31, 1978**

| *Treaty with* | *Concerning* | *Concluded* | *Official text* | *Published in the English language in* |
|---|---|---|---|---|
| Belgium | income | October 24, 1973 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 349 |
| Canada * | income | October 15, 1976 | English | AP treaties<br>IX UN A(1) 369 |
| Denmark | income | December 4, 1970 | English | AP treaties<br>IX UN A(1) 327 |
| France | income | April 24, 1975 | French and Malaysian | AP treaties |
| German Federal Republic * | income, capital | April 8, 1977 | German, English and Malay | AP treaties |
| India | income | October 25, 1976 | English, Hindi and Malaysian | AP treaties |
| Japan | income | January 30, 1970 | English | AP treaties<br>IX UN A(1) 282 |
| New Zealand | income | March 19, 1976 | English | AP treaties |
| Norway | income | December 23, 1970 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 342 |
| Poland * | income | September 16, 1977 | English, Polish and Malaysian | AP treaties |
| Singapore | income | December 26, 1968 | English | AP treaties (text as amended) |
| Supplementary agreement | income | July 6, 1973 | English | |
| Sri Lanka | income | September 16, 1972 | English, Sinhala and Malaysian | AP treaties |
| Sweden | income | November 21, 1970 | English | AP treaties<br>SUPP. SER. Section C |
| Switzerland | income | December 30, 1974 | German and Malaysian | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 360 |
| United Kingdom | income | March 30, 1973 | English | AP treaties<br>SUPP. SER. Section C<br>IX UN A(1) 301 |

* Not yet in force.

**Abbreviations:**

AP treaties = Taxes and Investment in Asia and the Pacific. Part treaties (in preparation).
SUPP. SER. Section C = Supplementary Service to European Taxation, Section C.
UN = United Nations. Department of Economic Affairs. International Tax Agreements. World Guide. Text of tax treaties exists in an English and a French edition. This publication contains several volumes.

# TAX GLOSSARY

by H.W.T. PEPPER *

**FACTORS OF PRODUCTION, TAX ON** — Some theories of taxation propose the taxation of factors of production, either to induce economy in the use of particular factors or as an allegedly superior way of taxing "ability to pay". Payroll taxes, however, are more often levied merely as a handy way of generating revenue than as an economically-oriented charge on labour as a factor or production. An example of the latter charge was the SELECTIVE EMPLOYMENT TAX (q.v.). Some theorists have suggested a tax on power, e.g., electricity and fuels, on the basis that the greater the affluence of an individual and the greater the productivity of a business, the larger is likely to be the dependence on sources of power, so that the tax payable would be proportionate to taxable capacity.

**FAIR MARKET VALUE** — The fair market value (FMV) basis adopted for Canadian customs duty purposes refers to the value in the country of export at the time the goods were shipped. The value must be the ARM'S LENGTH PRICE (q.v.) and is defined in detail in Section 35(1) of the Customs Act. For example, the price must be that at which goods were sold to two or more customers, not the price of a special one-off deal. The FMV basis for import duties is applied in comparatively few countries (Australia and New Zealand are other examples), the more widely used basis being C.I.F. value (q.v.).
Fair Market Value (or "Open Market Value") is applied in Japan to represent disposal price for capital gains tax purposes where property is donated, bequeathed or devied. FMV is, of course, widely used as the criterion for income and other taxes where assets change hands gratis or for inadequate consideration.

**FAMILY** — Although the individual is commonly the person assessed to personal income tax, a number of countries aggregate the income of both spouses (which may bring the total income into a higher tax bracket) for tax purposes and some go further and aggregate the income of minor children (Sri Lanka and Italy) or disallow or ignore annuities etc. provided for minor children by their parents under settlements which would otherwise reduce the tax liability of the settlor. Taking the family (even the household, including servants, relatives, etc. living in) as a unit may be resorted to in evaluating FRINGE BENEFITS (q.v.) from an employer. (See also AGGREGATION.)

**FAMILY ALLOWANCE** — In Britain the term is applied to weekly cash payments in respect of dependent children, payable to the mother so that there is less likelihood of the money being wasted. Such payments in recent years have been subject not only to income tax on the recipient's husband, but also "clawback", i.e. tax at above normal rate where income is above a certain level. In Britain, and in some other countries, it is intended that eventually family allowances for children will replace altogether child relief as a deduction in computing income tax. (See also CHILD.)

**FAMILY CORPORATION** — A private company in which the controlling interest is held by an individual and his family. (See also CLOSE COMPANY, PERSONAL HOLDING COMPANY.)

**FAMILY INCOME SUPPLEMENT** — The term is used for social welfare benefits to lower-income groups in the British social welfare system. The Social Security Department issues a kind of "passport" where the family income is below a certain level which provides for five different types of benefits to the family. (See also INCOME TAX, NEGATIVE; POVERTY SURTAX.)

**F.A.S. (Free Alongside Ship)** — The F.A.S. price of a commodity will be lower than the F.O.B. price because the buyer has to pay for loading on to the ship. (See also C.I.F., F.O.B.)

**FEMME SOLE** — A legal concept of relevance for income tax computation purposes in countries which normally aggregate the income of husband and wife. Where husband and wife are resident in different countries, not through domestic disharmony, but, e.g., because of business or employment in the respective countries, so that they have in effect "two homes", the wife may be treated as a single person and be granted personal reliefs and graduated tax rates accordingly.

**FEUDAL DUES** — Certain dues, payable originally by those owing allegiance to a feudal lord, were traditional to the feudal or manorial system in Europe and in Britain. In some cases these dues have survived as forms of local taxation after the end of the feudal system, for example, as charges for services rendered by a local authority or as registration fees on the registering of births, marriages and deaths, or the setting up and carrying on of various types of business. (See also SCUTAGE.)

**FEU DUTY** — The term refers not to a type of taxation, but to "ground rents" in Scotland payable by a lessee to his "ground landlord". The payments relate to a system of property owning in Britain whereby a person may "rent" land (usually on a long term lease) on which to put up a building, instead of buying the site outright.

**FIDUCIARY ISSUE** — The part of the currency in issue in a country which is not covered by gold or foreign currencies (or those of another country to which the local currency is linked), but usually by local gilt-edged securities. The income of the Currency Fund forms useful revenue to governments but the proportion so invested must not be too large because of the need to cover the possibility of a run on the currency.

**F.I.F.O.** — A system of valuing stock in trade or inventory on the basis of "first in first out", i.e., the goods or materials in stock are regarded as those which have most recently been purchased when determining the cost price for valuation purposes. As regards the computation of capital gains tax liability, the F.I.F.O. rule is also applied (in the British system) by deeming disposals made, after a series of purchases, to relate first to the earliest acquisitions.

**FIFTEENTHS** — A 14th century levy in Britain based on the value of certain personal property in each area, the value of the property being fixed by the local authorities who were charged with the task of collecting a tax at the

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

rate of 1/15 of these values. (See also TENTHS.)

**FILIAAL** — (Holland) Branch office.

**FILIALE** — (France) Subsidiary company.

**FILM HIRE TAX** — The profit realised from the making of a motion picture depends on the earnings of the film during its lifetime, in the course of which it may be exhibited in a number of different countries. It is therefore postulated that some of the profit to the producers from exhibiting the film is derived from the various countries in which it is exhibited. The current determination of these profits is a virtually impossible task, as no one can forecast the exact life of a film, which may have a number of re-runs in subsequent years, and be re-used for television, and finally even be purchased for national film archives. Accordingly, some countries have legislated to provide for the arbitrary computation of profits on the basis of a percentage of the amounts paid for film hire or rental by the exhibitors (cinema proprietors). Where the tax charged is in the form of an income tax, the film producer may be able to obtain double taxation relief for the foreign taxes against the income tax charged in his home country on his total production and hiring profits. The usual form such a tax takes in the country where the film is exhibited is that a percentage of the gross hire or rental charge is deemed to be profit and a rate of tax applied to the net figure. (See also ENTERTAINMENT DUTY.)

**FILM RENTAL TAX** — See FILM HIRE TAX, also ENTERTAINMENT DUTY.

**FINAL REMUNERATION** — A concept involved in RETIREMENT BENEFIT SCHEMES (q.v.) which may be approved for income tax purposes in the U.K. Final remuneration is defined as the average of the last 3 years' remuneration, and for the first 2 of those 3 years. Indexation is applied, i.e., the pay is adjusted by reference to the Index of Retail Prices.

**FINAL TAX** — Where provisional tax is levied, usually where income tax is charged on current income, a further payment usually becomes due when the final computation of tax is made, and this is sometimes referred to as "Final Tax".

**FINANCIAL CENTRE** — The term is more or less a euphemism for "Tax Haven", in an attempt to achieve respectability for the haven services offered by the country concerned. There is, however, a tendency to avoid the grosser abuses of havens, e.g., by vetting more thoroughly the persons involved and their operations in the case of offshore bank and trust business, and also to offer more orthodox services in some of the better known havens.

**FIRST IN FIRST OUT** — See F.I.F.O.

**FIRST LETTING TAX** — A form of capital gains tax payable not on the realisation of an asset, but upon its having developed an income potential. The tax is charged under the Development Land Tax in Britain as from 1976, and applies after material development of a site when over 25 percent of the buildings erected have been let. Tax is charged at 80 percent on the excess over £160,000, the first £10,00 being exempt and the next £150,000 being taxed at 66 2/3 percent, and deductions are permitted on cost plus development expenditure increased by various percentages, which have a sort of indexing effect in computing the taxable surplus of realised or, in the case of first lettings, the deemed realised value of the development.

**F.I.S.C.** — See FOREIGN INTERNATIONAL SALES CORPORATION.

**FISCAL BOOST** — The advantage gained by the taxpayer when taxes fixed in money terms are not adjusted upwards by the Government sufficiently to counterbalance inflation at a time when the monetary unit is losing value in real terms. (See, by contrast, FISCAL DRAG.)

**FISCAL DRAG** — Graduated systems of income taxation have an in-built tendency to depress demand in a period of inflation because with the decrease in the value of money the reliefs and allowances deductible in the tax computation become worth less in real terms, and similarly the bands of taxable income chargeable at the lower rates of tax shrink in real terms for the same reason, so that a larger proportion of what may be the same real income becomes taxable at higher tax rates. Persons with fixed or slowly increasing real incomes and, therefore, more rapidly increasing money incomes therefore become liable for proportionately higher amounts of income tax, thus sometimes suffering an actual reduction in real income because of this "fiscal drag".

It is therefore necessary, if a government does not wish its income tax system to become steadily more severe in times of inflation, to make periodical "corrections" by increasing reliefs and deductions and widening the bands of income taxable at lower rates.

**FISCAL OASIS** — This term, which is of German origin, is equivalent to the more familiar term TAX HAVEN (q.v.).

**FISCAL SANCTIONS** — Penalties imposed in connection with the administration of taxation of all kinds, e.g., for lateness in rendering tax declarations, or in paying tax, or for making misstatements or omissions in tax declarations, are sometimes called "fiscal sanctions".

**FISCAL TAXES** — This term is sometimes used (in contrast with the term "Revenue Taxes") to denote taxes which have some fiscal purpose other than merely producing revenue, e.g., to curtail consumption, or encourage one form of development rather than another.

**FISCALE EENHEID** — (Holland) Integration of one business enterprise into another for tax purposes.

**FISCALITE IMMOBILIERE** — (France) A special tax regime pertaining to the taxation of certain real property transactions.

**FITRAH** — A moderate tax sometimes levied in Moslem countries in accordance with Koranic precepts generally as a levy on the more affluent for the benefit of the poor. (See also ZAKAT.)

**"FITTED CARPET CAPER"** — This term has been applied to a form of tax avoidance in respect of sales taxation where new dwellings are exempted from tax (e.g., in order to stimulate the provision of new housing) and the builders then take advantage of the exemption to include various fixtures and equipment, including wall-to-wall carpeting, as part of the structure in an attempt to have these items exempted also from the sales tax.

**FIXED ASSETS TAX** — (Japan) Annual property tax levied by local authorities on real property and depreciable fixed assets.

**F.O.B. VALUE** — The F.O.B. ("free on board") value of goods excluding carriage, insurance and freight, i.e., roughly speaking, the domestic price in the country of origin which is sometimes used as the basis for the levying of customs duties. The basis is encountered in some countries where either freight represents an exceptionally large proportion of the price of commodities or in very small countries where it is administratively simpler to use the F.O.B. basis than C.I.F. values.

**FONCIERE, CONTRIBUTION** — (France) Land tax.

**F.O.R. VALUE** — The F.O.R. (free on rail) value is a concept similar to F.O.B. VALUE (q.v.) but the goods are loaded on a train instead of on a ship.

[to be continued]

# Bibliography

# Books

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

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Prüfung; Begutachtung; Beratung. By Karl Lechner. Vienna, Industrieverlag Peter Linde, 1978. 1166 pp.
Handbook on the activities of trust companies and chartered accountants. (B. 101.166)

## BELGIUM

### DE BELGISCHE BELASTINGEN

Tweede, herziene druk. By A. Tiberghien. Deventer, Kluwer, 1978. 100 pp., 21.75 Dfl.
Second revised edition of booklet describing the Belgian taxes levied as of April 1, 1978. Reference to double taxation treaties concluded by Belgium with a summary of the provisions of the treaty with the Netherlands. (B. 101.171)

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Grosvenor House, London, April 10 & 11, 1978. Speakers' Papers. London, Financial Times Limited, 1978. 89 pp.
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### 6. RICHTLINIE ZUR HARMONISIERUNG DER UMSATZ-STEUERN IN DEN EUROPÄISCHEN GEMEINSCHAFTEN

By Dieter Wachweger. Bonn, Stollfuss Verlag, 1978. 224 pp., 29.50 DM.
Text of the 6th EEC Directive on the harmonisation of turnover taxes in the EEC in the English, French, Italian and German languages with a short comment on each provision with respect to the effect of the Directive on German VAT law. (B. 101.175)

## DENMARK

### OECD ECONOMIC SURVEYS: DENMARK

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### GUIDE PRATIQUE DU CONTRIBUABLE 1978

Impôts sur les revenus, impôts locaux, plus-values. Paris, Revue de l'Enregistrement et des Impôts, 1978. 160 pp.
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## GERMAN FEDERAL REPUBLIC

### DOPPELBESTEUERUNGSABKOMMEN

Eni Leitfaden für die Praxis. By Dieter Grützner. Herne/Berlin, Verlag Neue Wirtschafts-Briefe, 1978. 240 pp., 48.— DM.
Practical guide on the causes of double taxation, possibilities to avoid double taxation and the use of treaties concluded by Germany for the avoidance of double taxation. The text of the revised OECD Model Convention and a list of German tax treaties up to date as per 1.1.1978 are appended. (B. 101.176)

### DIE GmbH & CO KG IM STEUERRECHT

2., erweiterte Auflage. By Helmar Fichtelmann. Cologne, Peter Deubner Verlag, 1978. 72 pp., 19.80 DM.
Monograph on the civil law and tax law aspects of the GmbH & Co KG (limited partnership with a limited liability company as the general partner) after the entry into force of the 1977 Corporate Income Tax Reform Law. (B. 101.211/211A)

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Annual guide consisting of information for filing 1977 returns for individual income tax. (B. 101.221)

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Munich, Verlag C.H. Beck, 1978. 240 pp., 24.— DM.
Handbook providing information for filing 1977 business tax returns. (B. 101.218)

### HANDBUCH ZUR KÖRPERSCHAFTSTEUERVERANLAGUNG 1977

Munich, Verlag C.H. Beck, 1978. 392 pp., 28.50 DM.
Annual handbook containing material for filing 1977 corporate income tax returns. (B. 101.220)

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Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer. Munich, Verlag C.H. Beck, 1978. 2520 pp., 112.— DM.
Annual guide consisting of information for filing 1977 returns for individual income tax, corporate income tax, business tax and turnover tax. (B. 101.208)

### HANDBUCH ZUR UMSATZSTEUER 1977

Munich, Verlag C.H. Beck, 1978. 900 pp., 43.50 DM.
Annual handbook containing material information for filing 1977 turnover tax returns. (B. 101.219)

### NIESSBRAUCH; ZIVILRECHT, STEUERRECHT

3. Auflage. By Rolf Mittelbach. Cologne, Peter Deubner Verlag, 1978. 80 pp., 19.80 DM.
Monograph on the usufruct concept in which the aspects of the issue are considered from the viewpoint of civil law and tax law. (B. 101.210/210A)

### STEUERRECHT

Ein systematischer Grundriss. 5. überarbeitete und erweiterte Auflage. By Klaus Tipke. Cologne, Verlag Dr. Otto Schmidt, 1978. 620 pp., 64.— DM.
This book provides a comprehensive description of the tax law of the Federal Republic of Germany. The concepts are systematically presented in theory and as applied in practice. (B. 101.160)

### DIE VERANLAGUNG 1977

Ergänzungsband Aussensteuerrecht; eine Zusammenstellung von steuerrechtlichen Vorschriften für Steuerinländer mit Auslandsbeziehungen und Steuerausländer mit Inlandsbeziehungen. Mit ausführlichem Stichwortverzeichnis. Düsseldorf, IdW-Verlag, 1978. 418 pp., 26.— DM.
Supplementary volume for purposes of the 1977 assessment year with respect to the Foreign Tax Law. Both tax aspects of residents with foreign source income and non-residents with German source income are discussed. The text of relevant statutes is appended. (B. 101.206)

### DIE VERANLAGUNG ZUR EINKOMMENSTEUER FÜR 1977

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Annual guide containing the text of the business tax law, the regulatory ordinance to the business tax law, case law and other relevant material for the 1977 tax assessment year. (B. 101.203)

### DIE VERANLAGUNG ZUR KÖRPERSCHAFTSTEUER FÜR 1977

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Analysis and possible uses. By Chrysses Demetriades. Limassol, Cypropublico, Ltd., 1978. 103 pp., $ 15.—.
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Basic documents. Compiled and edited by A. Peter Mutharika. Volume 1, 1978. New York, Oceana Publications, Inc., 1978. 646 pp., $ 40.—.
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### TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

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Information guide on business transactions in Malaysia covering banking and finance, forms of doing business, investment incentives, taxation and other connected issues. (B. 51.019)

## THE NETHERLANDS

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12e druk, 1 januari 1978. By H.J. Doedens. Deventer, Kluwer, 1978. 20 pp., 7.25. Dfl.
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# Cumulative Index 1978 ~ Nos. 1-7

I. ARTICLES

# Contents

of the October 1978 issue



**In next issues:**

Perspectives on wealth taxation
— by *Richard H. Bird*

Some international problems relating to the taxation of interest
— by *R.V. Giddy*

Thailand: Taxation of corporate foreign investment income
— by *M.P. Dominic*

Compensation of expatriates transferred to Brazil
— by *Aleksas Juocys*

Les Conventions Fiscales franco-luxembourgeoise et franco-belge répondent-elles aux nécessités actuelles?
— Deuxième Partie

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

Dr. Erwin Spiro:

# The South African Sales Tax 1978

## (Act No. 103 of 1978)

### I. Introduction

1978 will stand out in the history of South African tax legislation as a year of a distinct switch from direct taxation to indirect taxation: instead of increasing the income tax, the Legislator introduced, with effect from 3rd July, 1978, the so called sales tax. The rate is throughout four percent. The tax is not a value added tax and is administered by the Department for Inland Revenue.

To understand the Act, one must first have acquired a working knowledge of its shorthand-like vocabulary contained in its section one. For instance, 'sale' includes an exchange or, subject to certain exceptions, a donation (but not acquisitions by virtue of testate or intestate succession), but a transaction for the purchase or sale of foreign exchange is excluded. Or 'purchaser' includes, besides a purchaser in the ordinary sense, a lessee under a financial lease, a person liable for the payment of any rental consideration under an operating lease and a lodger or boarder to whom board and lodging or accommodation is supplied, 'seller' being the counterpart of 'purchaser'. A 'vendor' is a person who carries on an 'enterprise' which, in turn, includes, besides the enterprises of merchants, also financial enterprises entering into financial leases, ordinary leasing enterprises, certain service enterprises, certain accommodation establishments, certain hotel and boarding house enterprises, manufacturing enterprises, certain mining, quarrying, farming, forestry and fishing enterprises and auctioneering enterprises, etc., etc.

### II. Levy of tax

The tax is levied on:-

1. *Sales* of new and used movable goods to end-consumers or -users, sales of fixed property thus not being subject to the tax. The sale of trading stock in the ordinary course of an enterprise is exempted if the gross receipts or accruals do not exceed the sum of five thousand rand annually, and so are occasional sales, as defined, if the total consideration does not exceed one thousand rand. The sale of goods constituting assets of an enterprise or other commercial, financial, industrial, mining, farming, forestry or fishing concern or of any professional practice — if such enterprise or concern or practice is, together with all the assets thereof, disposed of to the purchaser as a going concern — also does not attract the tax. On the other hand, the tax extends to goods acquired in carrying on an enterprise (on which the tax was not yet paid when they were purchased) and goods manufactured, assembled or produced in carrying on an enterprise if the goods are applied to private or domestic use or consumption or to use or consumption in the enterprise or for the use or consumption of any person other than the owner of the enterprise or for the purposes of any other enterprise carried on by the same owner.

What matters is the date of conclusion of the sale which is deemed to be the date on which delivery of the goods is effected under the sale or the date on which the consideration payable by the purchaser under the sale is paid in full, whichever date is earlier.

2. *Leased property* delivered to a lessee under a financial lease.

3. *Rental considerations* accruing to a person in respect of goods.

4. *Services* rendered by a person in the course of an enterprise carried on by him if they are deemed to be taxable in terms of the First Schedule to the Act. These include the customary repair and maintenance services, the services of tailors, barbers, hairdressers, cleaners, locksmiths, printers, photographers, animal care services (other than veterinary services), etc., etc. The services of lawyers, accountants and similar advisers are not mentioned in the First Schedule and, therefore, not subject to the tax nor are services rendered or facilities provided in a registered hospital or nursing home or a clinic operated by a local authority.

5. *Board and lodging* supplied by a person carrying on an hotel enterprise.

6. *Accommodation* let and supplied to an occupant for a period not exceeding forty-five days by a person carrying on accommodation enterprise.

7. *Importation* of goods by end-consumers.

### III. Further exemptions

There are many more exemptions than the few already mentioned. They are not so much based on the nature of the particular commodity, for instance, bread, butter, milk, eggs, etc., are not exempted (but electricity, telephone, telex, gas, water, banknotes, specie or gold or silver bullion, certain strategic materials, etc., are), as rather on considerations of the purpose for which the goods or services are destined, as e.g. in the case of exports (which are exempted) or of the use to which they are put by the purchaser, for instance the resale or manufacture for resale in another form — because the purchaser is then not the end-consumer — or certain transactions with or by registered charitable institutions or, except for the mining industry, the prevention of escalation of tax, i.e. so that tax is not levied on the same goods at different stages in a manner to increase significantly the effective tax payable by the end-consumer. Rental considerations payable in respect of goods let under a rental agreement concluded outside the Republic if the goods are used exclusively outside the Republic are also exempted from the tax. These and many more exemptions are contained in section six.

Except for medicines or other goods supplied by them, professional services rendered by a registered medical practitioner, dentist, optometrist, homeopath, naturopath, herbalist, nurse, physiotherapist, chiropractor or ortoptist in the ordinary course of his practice as such, are not, in terms of the First Schedule to the Act, taxable services; nor are, under section six of the Act, services rendered wholly or mainly outside the Republic or any repair or maintenance services rendered in respect of a foreign-going ship or a foreign-going aircraft.

## IV. Registration of vendors

Persons carrying on enterprises are under a duty to furnish the Secretary for Inland Revenue with declarations containing information concerning their enterprises. The Secretary must then register that person as a vendor in respect of the enterprise in question if certain conditions exist, e.g. inter alia if the gross annual receipts or accruals of the enterprise from the sale of goods exceed five thousand rand or the Secretary is satisfied that they will do so. A registration certificate is issued to every vendor who is registered for sales tax purposes. That certificate is the means by which the vendor may obtain free of tax goods for resale, raw materials or materials or components for manufacturing or processing into merchandise or specified imputs needed in the course of their enterprises by farmers, mining concerns, printers, fishing enterprises and hotel, accommodation and catering enterprises in order to produce marketable goods or services.

## V. Liability for the tax

The liability for the tax rests on the vendor who sells, imports, lets or himself uses or consumes goods or on the auctioneer who sells goods on behalf of his clients.

## VI. Recovery

The vendor may recover from purchasers the tax in respect of goods sold. This is achieved by means of an addition to the price for which the goods would have been sold if tax had not been applicable. The tax may either be included in the price of each commodity ('add-in' method) or it may be added to the total price of the transactions at the paying point on an invoice or cash slip. Only in the case of an auctioneer selling for a client and in respect of financial leases is the latter method, which is called the 'add-on' method, compulsory.

## VII. Taxable value, tax period, return, declaration, payment, assessments

The Act lays down how the taxable value must be determined. The tax periods applicable to an enterprise are the periods ending on the last day of each month or on a day within seven days before or after such last day or on such other day as the Secretary may approve. An enterprise must, within the period ending on the twentieth day of the first month commencing after the end of a tax period relating to the enterprise or, where such tax period ends on or after the first day and before the twentieth day of a month, within the period ending on such twentieth day, furnish a return and calculate and pay the tax. In other cases the person liable to the tax must, not later than the end of the period of ten days after the date on which such tax has become payable, furnish the Secretary with a declaration and calculate and pay the tax.

The tax is payable in respect of both cash and credit sales. But in the determination of the tax payable the amount of any debt due to the vendor in relation to his enterprise may be deducted to the extent to which it is proved to the satisfaction of the Secretary to have become irrecoverable and has been written off during the tax period, provided such amount has been included in any taxable value taken into account in respect of the enterprise, whether for the tax period or any previous tax period.

Where a person fails to furnish a return or declaration required or the Secretary is not satisfied with any such return or declaration or the Secretary has reason to believe that a person has become liable for the payment of an amount of tax without having paid it, the Secretary may make an assessment of the amount of tax payable and in making such assessment estimate the amount upon which the tax is payable. The Secretary must, however, before doing so, give the person in question a written notice of his intention to raise such an assessment.

## VIII. Tax relief allowable to certain diplomats

The Minister of Finance may, in consultation with the Minister of Foreign Affairs, authorize the granting of relief, by way of a refund, in respect of tax paid by any person enjoying full or limited diplomatic immunity under any law or agreement in force in the Republic or under the recognized principles of international law or by the wife, child or dependant of such person living with him, provided similar or equivalent relief is granted in the country, by which such person is employed, to any representative or employee of the Government of the Republic stationed in such country who enjoys full or limited diplomatic immunity in that country.

## IX. Prohibition against certain advertising

No vendor shall advertise or hold out or state to the public or to any purchaser, directly or indirectly, that the tax imposed by the Act or any part thereof will be borne or absorbed by him or that such tax will not be considered as an element in the price to the purchaser or, if added to such price, that such tax or any part thereof will be refunded. A violation of this provision constitutes an offence and is subject to criminal sanctions.

## X. Informal appeal to sales tax advisory committee

A person who is dissatisfied with a refusal by the Secretary to register him as a vendor or with the Secretary's proposal to cancel his registration certificate or with an assessment which the Secretary in terms of the required notification given by him intends issuing to him, may request that the matter be referred to a Sales Tax Advisory Committee for an opinion. Except in respect of the intended assessment, an opinion given by the Advisory Committee is final and conclusive against both the Secretary and the person or vendor concerned.

## XI. Objections and appeals

Objections may be lodged against assessments raised by the Secretary. If the Secretary refuses to allow them, an appeal lies to the Income Tax Special Court. The procedures are similar to those under the Income Tax Act, 1962 (Act No. 58 of 1962), as amended.

## XII. Special powers of Minister of Finance

The Minister of Finance may not only make regulations in regard to any matter which is permitted or required by the Act and generally for the better carrying out of the objects and purposes of the Act, he may also from time to time and when Parliament is not in session by notice in the Gazette vary or further vary the rate of tax by increasing or reducing it if such variation does not provide for an increase of more than two percent in the rate fixed or amend the Schedules to the Act.

# TAX REFORMS IN THE PHILIPPINES

*The Editors of the Bulletin are proud to publish two articles on Philippine taxation, both dealing with tax reform in that country. Mr. Yoingco deals with the more theoretical aspects whereas Mr. Gison places more emphasis on the details of the new tax legislation.*

*As may be noted these new measures are taken within the context of the "New Society". This term connotes the present arrangements — in all fields — which have been taken in the Philippines following the declaration of martial law in September 1972, which had as one of its objectives the realization of a rapid pace of economic development and the attainment of a more equitable distribution of wealth and income.*

*To accomplish these objectives the Government intends to activate all instruments of economic policy so as to fully mobilize their potentialities for the promotion of economic growth and social stability. One of these economic policy tools is taxation.*

*Note that the term "New Society" is chosen for this purpose as explained by President Marcos: "Because we are in a large sense a nation reborn. We walk with bigger steps because we have faith in ourselves. We are on a new voyage of discovery. We have arrived at the take-off period in our development, a new chapter which teems with promise and exitement." (Speech at the inaugural session of the Afro-Asian Rural Reconstruction Conference, February 24, 1975.)*

ANGEL Q YOINGCO*:

# TAX REFORMS UNDER THE NEW SOCIETY**

*Taxation has been assigned a crucial role in the Philippine development plan. It is expected to spur socio-economic development by financing the operating and developmental needs of the public sector. Therefore, the tax system has to be geared towards the effective fulfillment of its role. This paper summarizes the assessment of the reforms initiated by the New Society in the Philippine tax system with the aim of identifying its strengths and weaknesses. It also proposes certain recommendations that policy makers may consider for adoption.*

## A. REFORM OBJECTIVES

1. Tax reforms under the New Society have been generally aimed at overcoming the various problems under the old regime which impinged upon the operational efficacy of the tax system in the attainment of its goals. They seek to increase tax revenue and redistribute income and wealth; promote tax equity, progressivity and elasticity; make the tax structure a more potent instrument of national growth and development; and improve tax administration and the level of public tax consciousness.

## B. REFORM STRATEGY

2. The reform efforts encompass the three basic elements of the tax system, namely: tax structure, tax administration, and public tax consciousness. It is recognized that these elements are interdependent and interrelated with each other, and that they interact in such a way that a defect in the functioning of one element adversely affects the others as to cause a disfunction in the entire tax system. The reform movement, therefore, has concerned itself with strengthening the weak elements of the tax system in order that it could operate more efficiently and effectively towards the attainment of its goals.

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* Executive Director, National Tax Research Center, National Economic and Development Authority, Manila, Philippines.

** This is a summary of the research project undertaken by the author with the same title funded by the National Research Council of the Philippines.

**TABLE 1**

**Measures on taxation and those with tax provisions issued from September 21, 1972 to June 11, 1978**

| Nature of Decree/Tax Provisions | Sept. 21, 1972 to Dec. 31, 1973 | Jan. 1 to Dec. 31, 1974 | Jan. 1 to June 30, 1975 | July 1 to Dec. 31, 1976 | Jan. 1 to Dec. 31, 1977 | Jan. 1 to June 11, 1978 | Total |
|---|---|---|---|---|---|---|---|
| TOTAL | 98 | 69 | 28 | 85 | 32 | 26 | 338 |
| Amending the National Internal Revenue Code (NIRC) | 17 | 10 | 0 | 14 | 13 | 16 | 70 |
| a. Direct Taxes | 10 | 2 | 0 | 5 | 5 | 4 | 26 |
| b. Indirect Taxes | 4 | 5 | 0 | 7 | 7 | 7 | 30 |
| c. Allotment of Internal Revenue Taxes | 3 | 3 | 0 | 2 | 1 | 0 | 9 |
| d. Others | | | | | | 5 | 5 |
| Amending the Tariff and Customs Code (TCC) | 4 | 8 | 3 | 13 | 3 | 3 | 34 |
| Dealing with Local Finance | 11 | 10 | 1 | 10 | 4 | 2 | 38 |
| a. Real Property Taxation | 6 | 5 | 1 | 6 | 1 | 1 | 20 |
| b. Local Autonomy Act | 1 | 0 | 0 | 0 | 0 | 0 | 1 |
| c. Local Tax Code | 2 | 2 | 0 | 3 | 2 | 1 | 10 |
| d. Others | 2 | 3 | 0 | 1 | 1 | 0 | 7 |
| Granting Tax Amnesty | 16 | 1 | 3 | 0 | 0 | 0 | 20 |
| Amending or Enacting Incentive laws or granting Tax Concessions other than those provided under the NIRC or TCC | 41 | 33 | 15 | 37 | 9 | 4 | 139 |
| Levying or Amending Taxes, other than those imposed under the NIRC or TCC | 6 | 2 | 2 | 7 | 2 | 1 | 20 |
| Others | 3 | 5 | 4 | 4 | 1 | 0 | 17 |

## C. PERFORMANCE OF REFORM MEASURES

3. Since the establishment of the New Society, 341 Presidential Decrees (PDs) have been promulgated to introduce the reforms in the tax system.[1] The results have been encouraging especially in terms of revenues available for public expenditures. Total government tax revenues rose from ₱ 4 billion in 1970 to ₱ 17.5 billion[2] in 1975 for both the national and local governments, or an increase of 337.5 percent. More specifically, revenues from the corporate income tax grew at 35 percent after the inception of the New Society compared to its previous growth rate of 16 percent from 1970-71. The specific tax exhibited a growth rate of 82 percent as against its previous growth rate of 6 percent. Dynamism was likewise exhibited by the revenue effort which rose from 10.8 percent in 1970 to 15.8 percent in 1976.[3] A sustained increase in revenues is thus followed with an increasing quantity and quality of public services available to the Filipino people.

A change in the tax structure was also evident. Although the five major revenue sources before and after the institution of the New Society have been the same,[4] there were changes in the order of their importance. The export tax, premium duty and the amnesty tax rose in importance by being collectively the second major revenue source.

1. See Table 1.
2. Current exchange rate is ₱ 7.36 to 1 US dollar.
3. See Table 2. The revenue effort includes non-tax revenues although their share relative to the tax revenues is quite insignificant.
4. Import duty, corporate income tax, others (export tax, premium duty and amnesty tax), sales tax and the personal income tax.

The responsiveness of taxes to changes in income was also encouraging. Elasticity of all taxes was 1.19 which indicates that an increase in income means a slightly more than equal increase in tax revenues. However, the elesticity could have been caused by the tremendous increase in revenues from amnesty taxes, export taxes and premium duties. Knowing that said sources are not stable sources of revenue, some efforts have to be devoted to making the non-external taxes more revenue-productive.

An improvement in income distribution has been noted which is a positive factor in social development. According to the latest statistics on income distribution (1975) the share of income going to the lowest 50 percent of the Filipinos increased from 17.6 percent to 20.5 percent, a rise of almost 3 percentage points. This move towards social equity could have been the effect of the concerted fiscal policies; taxation being a tool in the reallocation of resources by broadening the hold of masses on the nation's wealth through an increase in the quantity of public goods and services.

### a. Tax structure

4. A number of decrees brought profound changes in the internal revenue structure. More notable among these is PD 69 (1972) which practically overhauled the National Internal Revenue Code. It was later re-enforced by PD 1158 (1977) which consolidated and codified into a single legal document all internal revenue laws embodied in the present Tax Code and the amendments thereto introduced by various laws and decrees. The New Society also is a witness to innovative tax measures and tax studies. The 35 percent tax on money market transactions and the 15 percent tax on interest on bank deposits have already generared ₱ 269.3 M and ₱ 263 M, respectively, six months after their effectivity. [5] Furthermore, under the new spirit of discipline, measures which have long been advocated such as the issuance of receipts for purchases above ₱ 5.00 could now be strictly implemented.

The year 1978 marks the introduction of more substantive tax reforms. PD 1357 updated the sales taxation of automobiles by changing the tax base and the tax brackets. Sales taxation has likewise been restructured under PD 1358 to make it more progressive and responsive to the requirements of a developing country. The major features of this decree are: the adoption of the Home Consumption Value (HCV) for determining the base of the tax; the standby authority of the President to subject the second sale of any article subject to percentage tax to a value-added tax (VAT); the reclassification of articles subject to the sales tax and revision of the tax rates. In addition, a system of socialized pricing for certain commodities, whereby the tax is graduated on the basis of the price, has been introduced.

5. Substantial reforms have likewise been effected in the tariff structure by PD 34 (1972). The 34 rate levels under the old law were reduced to only six at 10, 20, 30, 50, 70 and 100 percent *ad valorem.* Articles which were previously classified as "free" were subjected to the minimum 10 percent ad valorem, and those which fall under the category of "others" were subjected to the highest rate under each heading or subheading. Practically all alternative, compound and specific rates were abolished and only ad valorem rates were imposed. These long needed reforms contributed to the 32 percent increase in revenue one year later (1973), besides solving technical smuggling.

6. Export taxation was made a permanent feature of the Tariff and Customs Code with the promulgation of PD 230 (1973). Changes were made in the export tax structure by this and subsequent decrees to maximize its revenue productivity, encourage domestic processing or manufacturing of export products, and make it serve as an effective stabilization and anti-inflationary device.

7. In order to make local units effective partners of the national government in the task of nation-building, the local tax structures have been made the subject of various changes to increase their revenue potentials and improve administration. Presidential Decree No. 231 (1973), otherwise known as the Local Tax Code, allocated the taxing and other revenue-making powers of local governments, granted them new revenue sources and increased the existing tax rates in many instances. The system of local allotments has been revised under PD 144 (1973) to rectify the lopsided distribution of national funds among the local units. Moreover, PD 464 (1974), or the Real Property Tax Code, consolidated all decrees on real property taxation, provided uniform procedures for assessment and administration, and established the ranges of tax rates which may be imposed on real property.

8. Incentive taxation has been used extensively to influence the direction of investments. To date, some 131 presidential decrees have been promulgated since the inception of the New Society. The PDs encouraging the agri-business and the tourism industry stand out in addition to the Investment Incentives Act (1967) and the Export Incentives Act (1968) which have remained to be the major fiscal incentive laws. It is important to remember, however, that incentive laws represent some revenues foregone. Therefore, some serious rethinking has to be done along this line. As an initial step, PD 1352 (1978) imposed a five percent customs duty and five percent internal revenue tax on all importations which were formerly exempt from customs duties and/or internal revenue taxes.

### b. Tax administration

9. Tax administration has been revitalized by the various reforms introduced in both the Bureau of Internal Revenue and the Bureau of Customs. The reform efforts were designed to make these two bureaus more viable machineries for the economical, efficient and effective discharge of the taxation functions of the government. The reforms have been directed at improving their organization, personnel and procedural set-up.

10. Major organizational changes have been effected in the two bureaus basically by PD No. 1 (1972), also known as the Integrated Reorganization Plan, and by

5. The figures are understated since the revenues represent the collection from only six administrative regions of the Bureau of Internal Revenue from June to December, 1977.

subsequent decrees. Their operations were decentralized to the regional and field offices; their staff services were reduced, integrated and streamlined; new units were created for functional and operational emphasis; and their non-revenue functions were transferred to more appropriate agencies of the government.

11. Reform measures, both drastic and positive, were likewise adopted to improve the personnel set-up of the two bureaus. Under LOI No. 14-A, revenue and customs functionaries who were considered notoriously undesirable were weeded out of office. This purging process continues to this day, besides the periodic reshuffling of personnel in the central and field offices, in order to rectify the unflattering public image of the two bureaus and inject into their human infrastructure the virtues of honesty, integrity and efficiency.

12. On the more positive side, a realistic staffing pattern and salary structure was established in the Bureau of Internal Revenue and the Bureau of Customs by PDs Nos. 640 (1975) and 689 (1975), respectively. A personnel revitalization project is being implemented through continuous training and career development of supervisors and rank-and-file personnel. In addition, the recruitment and promotional systems are being applied with more objectivity.

13. The operational procedures of the two bureaus have been subjected to major changes to promote economy, efficiency, expediency and effectiveness in the delivery of services. The internal revenue and tariff structures have been simplified by PDs Nos. 69 and 34, respectively, to facilitate their administration and delimit the exercise of discretion in tax assessment and collection functions which was one of the root causes of corruption. Moreover, the operational procedures of the two bureaus are being subjected to continuous study and reexamination for possible adjustments and readjustments to changing conditions.

14. In the Bureau of Internal Revenue, the package audit system was adopted to relieve taxpayers from multiple investigations by limiting the examination of records to only once in a taxable year during a five-year period. Tax payment through authorized agent banks has been allowed to minimize revenue losses through thefts and defalcations. Another big step was the establishment of a Taxpayers Master File and Information System through computerization. Presidential Decrees Nos. 1254 (1977) and 1255 (1977) were issued to tighten the regulations and impose stiffer penalties on the preparation, printing and non-issuance of commercial or sales receipts or invoices.

15. In the Bureau of Customs, the home consumption value (HCV) method of valuation has been adopted to curb undervaluation. The time for processing and release of imported cargoes was reduced from 10 to 15 days to only two or three days. The description and definition of articles have been made clearer and more definite by the adoption of the updated Brussels Nomenclature.

### c. Public tax consciousness

16. Decisive reform efforts to foster a more positive attitude on the part of the taxpaying public towards honest and voluntary compliance with tax obligations were launched immediately before and during the establishment of the New Society. In the school year 1970-1971, a long-range tax education program was started when taxation was included in the curricula of elementary schools through the joint effort of the defunct Joint Legislative-Executive Tax Commission (now National Tax Research Center) and the Department of Education (now Ministry of Education and Culture). To further implement the program, a Model Teaching Guide for High Schools has likewise been formulated. In 1974, the BIR and the DEC signed a memorandum of agreement for the teaching of taxation in all elementary and high schools which was implemented beginning the school year 1976-1977.

17. In order to probe into the causes or reasons for nonpayment or underpayment of taxes and come up with necessary measures to foster public tax consciousness, the JLETC launched nationwide tax consciousness surveys in 1961 and 1967 which were followed up by the NTRC in 1974. The findings of these surveys became the basis of various administrative reforms designed to raise the level of public tax consciousness. To attain the same objective, the Integrated Reorganization Plan institutionalized the fostering of public tax consciousness as a permanent function of government through the cre-

**TABLE 2**

**Government Revenues,* 1970-76**
**(In billions of pesos)**

| | 1970 | 1973 | 1976 |
|---|---|---|---|
| I. Total Revenue | 4.5 | 9.0 | 20.7 |
| Revenue Effort (%) | 10.8 | 14.7 | 15.8 |
| II. National Government | | | |
| A. Tax Revenue | 3.7 | 7.4 | 16.5 |
| Excise Taxes | .6 | .6 | 3.0 |
| License and Business Taxes | .8 | 1.3 | 2.8 |
| Income Taxes | .9 | 1.8 | 3.7 |
| Import Duties | .6 | 1.4 | 4.3 |
| Export tax and premium duties | .1 | .5 | .6 |
| Other taxes and duties | .3 | 1.1 | .9 |
| Social Security Contributions | .3 | .7 | 1.1 |
| B. Non-tax Revenue | .3 | .8 | 2.8 |
| Total National Government Revenue | 4.0 | 8.2 | 19.3 |
| National Government Revenue Effort (%) | 9.6 | 13.4 | 14.7 |
| III. Local Government | | | |
| A. Tax Revenue | .3 | .5 | 1.0 |
| B. Non-tax Revenue | .2 | .3 | .5 |
| Total Local Government Revenue | .5 | .8 | 1.5 |
| Local Government Revenue Effort (%) | 1.2 | 1.3 | 1.1 |

SOURCES OF DATA:
Bureau of International Revenue (BIR), Budget Commission (BC), Commission on Audit (COA), Annual Reports on Local Government, National Economic and Development Authority (NEDA), Social Security System (SSS) and Government Service Insurance System (GSIS) Annual Reports.

* Figures are rounded and thus may not equal the total.

ation of a Tax Information and Education Division under the Administrative Service of the Department of Finance. In the Bureau of Internal Revenue, a similar division was created in the central office and tax information units were installed in the various regional and district offices.

18. One of the most significant steps towards upgrading tax consciousness under the New Society which had far-reaching effects was the series of tax amnesties granted for untaxed income and wealth. There were serious qualms and apprehension about the granting of tax amnesties. Despite the lack of precedence, the government took the risk and the rest was history. The response to the tax amnesty program was so overwhelming in terms of revenues that it was extended in coverage through a series of presidential decrees. Notable among those was the amnesty on untaxed income initiated through PD 23 (1972) and three other PDs. PD 213 (1973), on the other hand, extended amnesty to non-filers of income tax returns and PD 52 (1972) proclaimed amnesty on untaxed or improperly taxed motor vehicles. The tax amnesty scheme was a breakthrough in fostering tax compliance, increasing the tax base and generating revenues. [6] It was therefore a bold step, but the effects justified the risk.

## D. CONCLUDING STATEMENTS AND RECOMMENDATIONS

19. Despite the absence of a law-making body under the New Society, up to June 11, 1978 [7] the tax legislation process has been objectified through the establishment of a mechanism for tax research, planning and policy formulation within the governmental bureaucracy. This mechanism serves to seek out public and private sector opinion on proposed tax measures, including the tax practices and experiences in other countries, before any definite tax plan is formalized for review by higher authorities. At the review level, the technical and policy views of government officials involved in fiscal and development planning are brought into the proposed tax measure before the same is formulated into a decree for the consideration of the President.

20. Through the present tax research, planning and formulation mechanism, substantial headways have been achieved to make the tax system a potent instrument of national growth and development. Tax revenue has increased tremendously under the New Society, [8] thereby underscoring the active participation of taxation and other fiscal tools in raising output and employment levels and in broadening investments in desired areas of development. The major considerations which underly the tax reform efforts revolve around the overall national goals of accelerating the pace of industrialization, generating employment, stabilizing the monetary system, increasing revenue and effecting a more equitable distribution of income.

21. There are still many areas in the elements of the tax system which need further improvement. These are the needed responses to the challenge of development. Specifically, the needed reforms would have to be directed towards: (1) broadening of the tax base; (2) improvement of the revenue administration; (3) strengthening of the local government's fiscal capacity; and (4) restructuring the tax system in order to attain progressivity in indirect taxation, heavier reliance on direct taxation and lesser dependence on foreign trade taxation.

22. The tax base will have to be broadened. To effect such, reforms in tax and tariff areas will have to be introduced. For the income tax, deductions will have to be re-examined and changed. Alternative income tax systems like the gross income taxation will have to be studied.

The possibility of broadening the tax base of the transfer taxes should also be looked into. Reforms should concentrate on the limitation of deductions from the taxpayer's estate.

The present system of fiscal incentives would also have to be rationalized vis-a-vis other government priorities.

23. The elasticity of major tax sources will also have to be re-examined to bring about an automatic response in tax yield relative to increases in income and prices.

24. Reforms in tax structure would have to be complemented with a continuous improvement in tax administration. There has to be more fervor in the enforcement of tax laws. Government collecting agencies should be further reorganized and streamlined and tax administration should be simplified. A more aggressive stance would have to be put up in raising the tax consciousness of the citizenry.

25. To enable local governments to become effective partners in nation-building, their fiscal capacity would have to be strengthened. Towards this goal, reforms on local finance are envisioned. Biases in the national-local tax sharing formula will have to be discarded to allow lower-income municipalities to receive a bigger portion of national allotments. The collection efficiency of local units should be improved. In addition, non-productive taxes would have to be eliminated and exemptions from local taxes need to be rationalized.

26. On the other hand, direct taxation would have to be utilized more effectively. New tax concepts and measures especially for sectors which are under-taxed at present would have to be developed. The promising areas for exploration are the basic real property tax and the tax on agricultural income.

27. A move towards less dependence on foreign trade taxation is also expected if the development program is to have a more stable internal revenue base. This implies an increasing reliance on non-external trade taxes. Despite this shift however, export taxes should continue to be an important instrument in promoting and restructuring the export sector.

The New Society has caused significant reforms in the tax system but research and improvements on the said field must constantly be undertaken. In the course of its growth, policy makers and administrators should take a comprehensive view of the tax structure and devise measures for improvement which are integrated and at the same time akin to national goals.

6. Estimates place total revenue generated by the tax amnesty at ₱ 1.1 billion.

7. The Philippine Parliament (known as the Interim Batasan Pambansa) was convened on June 12, 1978.

8. See Table 2.

# RECENT CHANGES IN THE PHILIPPINE TAX CODE*

By CORNELIO C. GISON**

## TABLE OF CONTENTS



## INTRODUCTION

*On June 3, 1977, substantial changes in the Philippine national internal revenue system were introduced by Presidential Decrees (herein referred to as PDs) 1158 and 1158-A, otherwise known as the "National Internal Revenue Code of 1977" (herein referred to as the Tax Code of 1977). These decrees not only consolidated and codified all internal revenue laws but also amended existing laws and added new provisions. Last April 21, 1978, the President (now Prime Minister) issued a series of PDs which also touched on the tax structure and administration. On June 11, 1978, the President signed PD 1457 which substantially amended the Tax Code of 1977.*

*This article will summarize these changes. It will compare the prior and present laws and the reasons, if given, for the changes.* [1]

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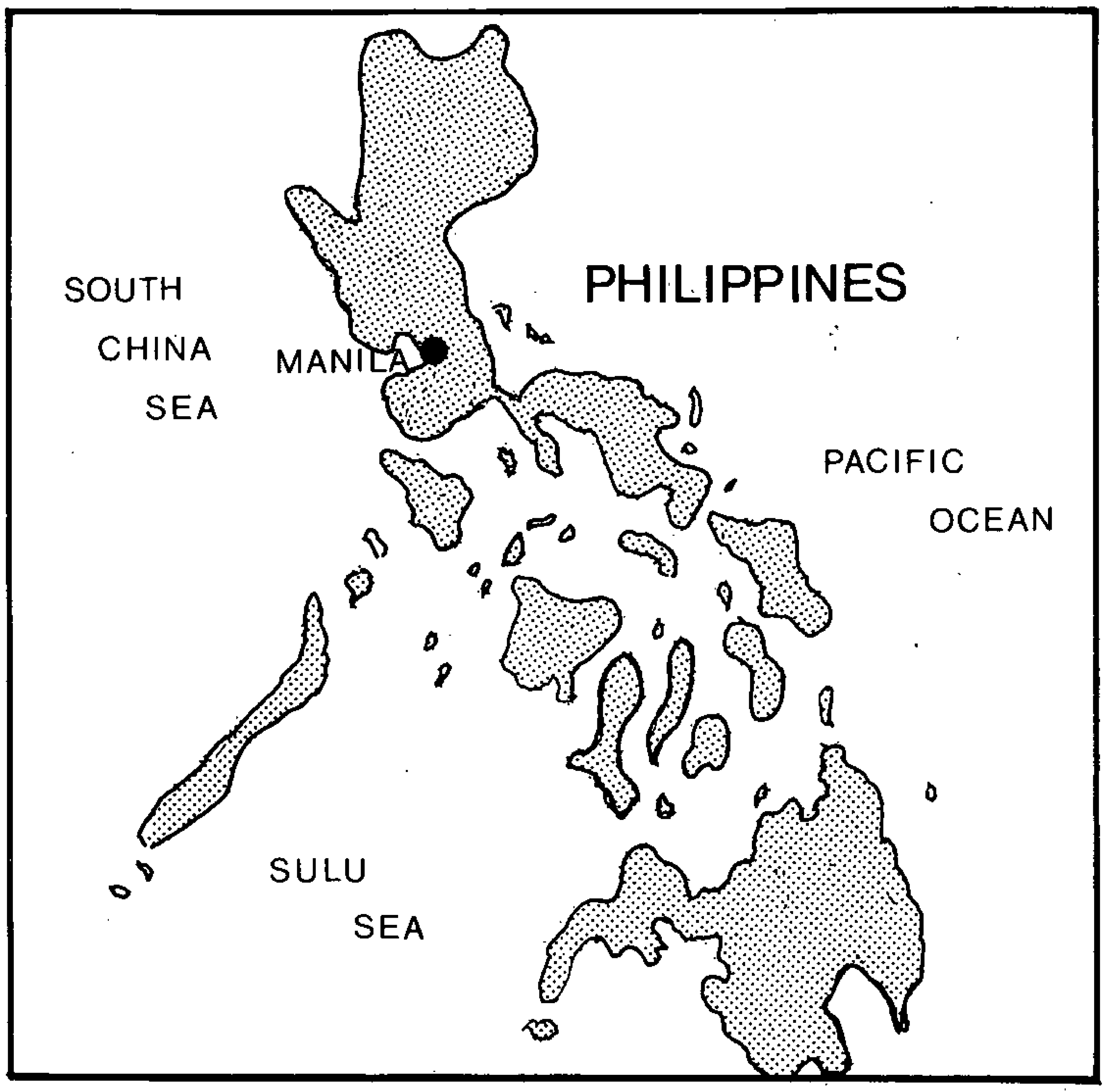
* As of July 31, 1978.

** Principal, Tax Division, SyCip, Gorres, Velayo & Co., Philippines.

1. For a detailed explanation of the changes introduced by the Tax Code of 1977, please refer to the Report of the Commissioner of Internal Revenue appearing in Philippines Law Gazette, Vol. 4, No. 5, September 1977, p. 1.




*This article will not go into a detailed analysis of the changes. Its purpose is merely to present general information about such changes. It is suggested, therefore, that no action should be taken as a result of the information contained herein without prior confirmation from counsels.*

## A. INCOME TAX

### a) 5 percent Corporate development tax

*Prior law*

The corporate income tax rates were: for domestic corporations (incorporated under Philippine laws), 25 percent on the first ₱100,000 of net taxable income from world-wide sources and 35 percent on the excess, except that any foreign tax paid could normally be claimed as tax credit under the "per country" and "overall" limitations; while for resident foreign corporations (branch), the same rates applied but based on net taxable income from Philippine sources.

*Present law*

In addition to the above tax rates, Section 24(e) of the Tax Code of 1977 imposes a tax of 5 percent (known as the 5 percent corporate development tax) on the same tax base subject to the 25-35 percent rates if:
(1) in the case of a domestic corporation, it is closely-held or its net taxable income exceeds 10 percent of its net worth, and (2) in the case of a resident foreign corporation, its net taxable income exceeds 10 percent of its net Philippine assets. The 5 percent tax is based on the entire taxable net income and not merely on the income net of the 25-35 percent tax rates. The 5 percent tax is effective starting June 3, 1977.
A closely held corporation is one which is owned, directly or indirectly, by or for not more than five persons, whether natural or juridical.

### b) Reduction of branch profit remittance tax

*Prior law*

Under PD 778 which took effect on August 24, 1975, any profit remitted by a branch (except an enterprise registered with the Export Processing Zone Authority) to its head office abroad was subject to a 20 percent tax.

*Present law*

The Tax Code of 1977 (Section 24(b)(2)) reduced the branch profit remittance tax from 20 percent to 15 percent.

*Reason for change*

Before PD 778, a branch as compared to a subsidiary had a decided tax advantage since the branch could remit its after-tax profits to its head office without any additional tax. On the other hand, a subsidiary when it remitted its after-tax earnings as dividends to its foreign parent company was generally subject to a 35 percent withholding tax. PD 778 was, therefore, issued to remove such tax advantage of the branch. However, it was realized later that under certain conditions, the dividend remittance by a subsidiary to its parent was subject to a withholding tax of only 15 percent. The reduction, therefore, is intended to place a branch on a parity with a subsidiary in a situation where the 15 percent withholding tax rate will apply on the dividends to be remitted.

### c) Increase in tax on cinematographic film owners, lessors or distributors

*Prior law*

The gross film rentals paid to non-resident cinematographic film owners, lessors or distributors were subject to 15 percent withholding tax.

*Present law*

Section 24(b)(1)(iv) of the Tax Code of 1977 increased the withholding tax rate from 15 to 25 percent.

*Reason for change*

The primary purpose of the 5 percent corporate development tax is to raise additional revenues. Its imposition was also guided by the fact that Philippine corporate income tax rates are generally lower than those imposed by other developing Southeast Asian countries. The 5 percent tax will raise corporate taxation in the Philippines to a level reasonably comparable with the effective corporate tax rates in the developing Southeast Asian countries and also with the effective corporate tax rates in capital-exporting countries, like the United States.
In the case of closely-held corporations, the 5 percent tax is imposed regardless of the rate of return on investments. Its purpose is to encourage family corporations to broaden their ownership base which is in line with the Government's policy of promoting a more equitable distribution of wealth.

*Reason for increase*

In tax treaty negotiations, the Philippines usually agrees to a reduction of the withholding tax on royalties or similar payments in consideration for the transfer of technical know-how from abroad to the Philippines from 35 to 25 percent. However, countries with which the Philippines negotiates usually argue that there is no reason why the Philippines cannot reduce the tax on such royalties to 15 percent if the Philippines imposes only a 15 percent tax on foreign film rentals. Hence, to avoid placing the Philippines in a defensive and awkward position in treaty negotiations, the withholding tax rate was raised to 25 percent.

### d) Reduction of tax on rentals or charter fees payable to non-resident owner of vessels

*Prior law*

The charter fee or rental paid to non-resident corporate owners of foreign vessels was subject to a 35 percent withholding tax.

*Present law*

Section 24(b)(1)(v) of the Tax Code of 1977 provides that rentals, leases, and charter fees payable to non-resident owners of vessels chartered by Philippine nationals and which charter or lease has been approved by the Maritime Industry Authority shall be subject to 4.5 percent final withholding tax.

A Philippine national includes a citizen of the Philippines, or a Philippine corporation 60 percent of whose voting stock is owned by such citizens and 60 percent of its board of directors are Filipino citizens.

*Reason for change*

Although the Government has granted incentives to Philippine nationals to acquire vessels for coastwise and international traffic, local companies would rather hire or charter foreign vessels instead of constructing due to the high cost of ship construction and the inadequacy of capital. Since the local company normally assumes the 35 percent tax on the charter fee or rental, it had become prohibitive to hire a foreign vessel. In order, therefore, to increase the availability of foreign-owned vessels for charter or hire by local shipping companies, it was decided to reduce the tax from 35 percent o 4.5. percent. The reduced rate of 4.5 percent is actually the 2.5 percent income tax and the 2 percent common carrier's tax imposed on the "gross Philippine billings" of resident international carriers.

### e) Taxation of subcontractors engaged in petroleum operations

*Prior law*

1. A foreign service subcontractor, which is a non-resident foreign corporation, of a service contractor engaged in oil operations in the Philippines is subject to a 35 percent withholding tax on its gross income from Philippine sources (fees paid for services rendered in the Philippines).

2. If the foreign service subcontractor is a resident foreign corporation, it is subject to the following major taxes: the 3 percent independent contractor's tax on gross receipts; the 25-35 percent corporate income tax on net Philippine income from Philippine sources; the 5 percent corporate development tax, if applicable; and, the 15 percent branch profit remittance tax.

3. If the subcontractor is a locally incorporated company, it is subject to the following taxes: 3 percent contractor's tax; the 25-35 percent corporate income tax on net world-wide income; the 5 percent corporate development tax, if applicable; and, the 35 or 15 percent withholding tax on dividends paid to its non-resident foreign corporate stockholders.

4. With respect to alien expatriates or subcontractors, they are taxed as follows:

a) If the expatriate is a non-resident alien not engaged in trade or business in the Philippines, he is subject to a 30 percent withholding tax on his gross Philippine income (compensation paid for services rendered in the Philippines irrespective of place of payment).

b) If the expatriate is a non-resident alien engaged in trade or business in the Philippines, he is subject to the usual graduated individual tax rates (ranging from 3 to 70 percent) but only on his net Philippine income.
A non-resident alien whose aggregate stay in the Philippines during the calendar year does not exceed 180 days is presumed to be engaged in trade or business in the Philippines.

c) If the expatriate is a resident alien, he is subject to the usual graduated rates of 3 to 70 percent on his net world-wide income.

*Present law*

1. Under PD 1354 which took effect on April 21, 1978, every domestic or foreign subcontractor, whether resident or non-resident, entering into a contract relating to oil operations with a service contractor engaged in petroleum operations in the Philippines is subject to a final withholding tax of 8 percent on its gross contract income, which shall be in lieu of all taxes, national or local. The service contractor is constituted as the withholding agent. Any income received from sources other than the contract shall be taxed under the old system.

2. Alien expatriates who are permanent residents of a foreign country shall be subject to a final withholding tax of 15 percent on their gross income received from the subcontractors or service contractors. Any income received from all other Philippine sources shall be taxed under the old system. If the employer is a domestic subcontractor, it shall act as the withholding agent. If the subcontractor is foreign, the service contractor shall act as the withholding agent. The service contractor shall likewise act as the withholding agent for its own alien expatriates.

3. The subcontract must be registered with the Bureau of Energy Development (BED). The cost of subcontract shall form part of the reimbursable operating expenses of the service contractor only if it has been registered

with the BED and the taxes due under PD 1354 have been paid.

*Reason for change*

PD 1354 seeks to simplify the method of taxing foreign oil subcontractors and alien employees involved in petroleum operations in the Philippines. The Decree grew out of the realization that foreign subcontractors perform transitory activities and do not maintain regular offices or keep books of account in the Philippines, thus making it difficult to determine their proper tax liabilities. This is likewise true with their foreign expatriates. The Decree seeks also to place domestic subcontractors on a tax parity with foreign subcontractors.

### f) Tax on international carriers

*Prior law*

Under Section 24(b)(2) of the Tax Code of 1977, international carriers are subject to income tax of 2.5 percent of their "gross Philippine billings". Revenue Regulations 3-76 define "gross Philippine billings" as the "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, cargo or mail, provided the cargo or mail originates from the Philippines. The gross revenues realized from the said cargo or mail shall include the gross freight charges up to the final destination". It was not then so clear whether fares of chartered flights originating from the Philippines were subject to the 2.5 percent tax.

*Present law*

PD 1355 which took effect on April 21, 1978 amended Section 24(b)(2) by adopting in the Tax Code of 1977 itself the definition of "gross Philippine billings" of Revenue Regulations 3-76 and including in such definition "gross revenues from chartered flights originating from the Philippines". The term "originating from the Philippines" shall include flights of passengers who stay in the Philippines for more than 48 hours prior to embarkation.

*Reason for change*

The amendment was to place beyond doubt the taxability of fares for chartered flights originating from the Philippines.

### g) Exemption of foreign source pensions

*Prior law*

Under PD 220 effective June 20, 1973, "social security benefits, retirement gratuities, pensions and similar benefits received by retiring employees and workers, whether received from the Philippines or foreign government agencies and other institutions, private or public", were exempt from income tax. This Decree created some amount of confusion since there was an existing law (Republic Act 4917) which prescribes certain conditions for the tax exemption of any retirement benefits received under a private retirement plan. A literal interpretation of PD 220 appeared to allow unconditional exemption. The Bureau of Internal Revenue had to rule that PD 220 did not modify RA 4197 and that the benefits under a private retirement plan must meet the conditions of RA 4197 to be exempt from income tax.

*Present law*

Section 29(c) of the Tax Code of 1977 exempts from income tax retirement gratuities, pensions and other similar benefits received by residents or non-resident Filipino citizens or aliens coming to reside permanently in the Philippines if received from foreign government agencies and other institutions, public or private. Therefore, the taxability of any other retirement benefits received from domestic sources must still be judged under RA 4917.

*Reason for charge*

Section 29(c) has not really introduced a new tax rule. It merely clarified the scope of PD 220.

### h) Preferential income tax treatment of mutual life insurance companies

*Prior law*

Domestic and resident foreign mutual life companies are treated like ordinary corporations subject to the regular corporate income tax rates of 25 percent and 35 percent based on net worldwide and Philippine income, respectively.

*Present law*

Under Section 24(d) of the Tax Code of 1977, domestic mutual life insurance companies shall pay an income tax of 10 percent of their gross investment income derived from all sources consisting of interests, dividends, rents, net capital gains and income from any other business than life insurance. Resident foreign mutual life insurance companies (branches) pay the same 10 percent rate on the same items of gross income derived from Philippine sources.

*Reason for change*

Mutual life insurance companies are now given special tax treatment pursuant to the policy of the government to encourage "mutualization" of life insurance companies, which actually means the transfer of control of the company from the stockholders to the policy holders. Mutualization is encouraged to achieve the higher objective of the government of redistributing and dispersing wealth. Furthermore, mutualization partakes of the nature of a cooperative and, therefore, justifies a special tax treatment.

### i) Withholding tax on dividends and royalties

*Prior law*

Dividends paid to an individual were not subject to withholding tax. Only dividends paid by a domestic corporation to another domestic corporation or a resident foreign corporation are subject to a 10 percent final withholding tax. Likewise, royalties paid to resident individuals and domestic or resident foreign corporations were not subject to withholding.

*Present law*

The Tax Code of 1977 amended Section 53(3) by subjecting dividends received by individuals residing in the Philippines from a domestic corporation as well as royalties in any form, received by such individuals and domestic and/or resident foreign corporations from any person whether natural or juridical, to a withholding tax at source of 10 percent thereof. However, such tax withheld shall be credited against the income tax liability of the recipient taxpayer for the taxable year.

*Reason for change*

The most effective and convenient method of collecting taxes is through the withholding system. It is the intent of the government to expand the scope of the system of withholding tax at source which formerly was generally applied only to income payments to non-residents. Withholding of tax is feasible if the income is fixed or determinable like royalties and dividends.

### j) Tax on transactions by offshore banking units and foreign currency deposit units

*Present law*

The tax Code of 1977 incorporated as Sections 22(d) and 24(f) thereof the provisions of PDs 1034 and 1035 of September 30, 1976 granting tax incentives to the establishment of offshore banking units (OBU) and expanded foreign currency deposit units (FCDU) in the Philippines.

These incentives are:

a) *For OBUs*

1. Net income of OBUs from transactions with non-residents and other OBUs shall be subject to a 5 percent tax which shall be in lieu of all other taxes. Any income of non-residents from transactions with OBUs shall be tax-exempt.
2. Net income of OBUs from transactions with local commercial banks, including branches of duly authorized foreign banks, shall likewise be subject to the 5 percent tax, except net income from such transactions as may be specified by the Minister of Finance to be subject to the usual income tax.
3. Interest income from loans granted to residents (other than those specified above) shall be subject only to a 10 percent final withholding tax (Section 24(f) (l)).

b) *For FCDUs*

1. Net income by an FCDU from foreign currency transactions with non-residents, OBUs and FCDUs shall be subject to a 5 percent tax which shall be in lieu of all taxes, except net income from such transactions as may be specified by the Minister of Finance to be subject to the usual income tax.
2. Interest income by FCDUs from foreign currency loans granted to residents (other than those specified above) shall be subject to a final withholding tax of 10 percent.
3. Income of non-residents not engaged in trade or business in the Philippines from foreign currency loans to FCDUs shall be tax-exempt (Section 24 (f) (2)).

*Reason for change*

The Tax Code of 1977 merely codified the tax provisions of PDs 1034 and 1035.

### k) Withholding tax upon interest on bank deposits

*Prior law*

Interest on bank deposits is taxable. However, because of RA 1405 (Law on Secrecy of Bank Deposits) which prohibits the examination of bank deposits except under very limited conditions, the Bureau of Internal Revenue has been practically left without any means of effectively enforcing the income tax law on this type of income.

*Present law*

PD 1156, which took effect on June 3, 1977, amended Sections 30(b) (1) and 53(c) of the old Tax Code by requiring banks to withhold a 15 percent tax on interest on bank deposits (except interest paid or credited to non-resident alien individuals and foreign corporations), provided that no withholding shall be made if the total interest on all deposits by a depositor in any one bank at any time during the taxable period does not exceed ₱ 350 a year or ₱ 87.50 per quarter. However, if interest earnings exceed ₱ 350 a year, the tax shall be based on total interest and not merely on the excess.

The 15 percent withholding tax is not a final tax but can be credited against the final income tax of the depositor at the end of the year. The interest paid to the depositor can be deducted by the bank only if it has properly withheld the 15 percent tax. To still maintain the secrecy of bank deposits, the bank shall not divulge the names of the depositors when it files the withholding tax return.

*Reason for change*

As explained, even before PD 1156, interest on bank deposits was taxable. However, the problem has been the inability of the tax authorities to reach this taxable income by reason of the Law on Secrecy of Bank Deposits. Although PD 1156 seems to impose a new tax, it is merely a collection measure designed to strengthen tax administration. Since the tax on interest on bank deposits can be effectively collected through withholding and the withholding agent shall not disclose the names of the depositors, PD 1156 is a compromise of tax enforcement and RA 1405.

### l) Option to expense exploration and development expenditure

*Prior law*

There was no option to expense mining exploration and development expenditures. Such expenditures were to be recovered through cost depletion unless they were of a character subject to an allowance for depreciation.

*Present law*

PD 1353, which was signed on April 21, 1978 but which if effective starting January 1, 1978, added Section 30(g) (3) to the Tax Code of 1977. It granted the taxpayer an option of either using cost depletion or expensing the accumulated exploration and development expenditures as of January 1, 1978 as well as the exploration and development expenditures incurred during the taxable year. If the taxpayer chooses the latter, he can deduct the total exploration and development expenditures from taxable income but not to exceed 25 percent of net income from mining operations. The election is irrevocable and shall be binding in the succeeding taxable years.

The option does not apply to oil and gas exploration and development. The Oil Exploration and Development Act of 1972 provides that intangible drilling costs may be deducted in full while all tangible exploration costs such as capital expenditures and other recoverable capital assets are to be depreciated over a period of ten years. The option does not apply to expenditures which are of a character subject to allowances for depreciation.

*Reason for change*

When PD 69 substituted cost depletion for percentage depletion, mining companies were not too happy about the change. The Government was presented with requests for some speedier form of recovering exploration and development expenditures. Apparently, Section 30(g) (3) is its answer. It gives mining companies a type of accelerated deduction of exploration and development expenditures.

### m) Proof of casualty loss deductions

*Prior law*

A casualty loss deduction would be claimed by the taxpayer in his income tax return filed in the following taxable year. Generally, verification or substantiation of the loss deduction, which might be real or fictitious, could be very difficult particularly considering that audit of tax returns was not normally done immediately upon filing.

*Present law*

The Tax Code of 1977 amended Section 30(d) (l) (C) by requiring a taxpayer to submit a declaration of loss sustained from casualty or from robbery, theft or embezzlement during the taxable year within a period as may be prescribed by the Minister of Finance which shall not be less than 30 days nor more than 90 days from the date of occurrence of the loss. Failure to comply shall preclude the taxpayer from claiming the loss.

*Reason for change*

To facilitate proof or substantiation of incurrence of actual loss. This will also minimize claims for fictitious loss.

### n) Exemption from filing of individual income tax returns

*Prior law*

As a general rule, every citizen or resident alien having a gross income of ₱ 1,800 or more a year was required to file an income tax return even if there was no tax due thereon by reason of personal exemptions and deductions.

*Present law*

The Tax Code of 1977 amended Section 45(a) (3) by exempting from the filing requirement an individual taxpayer (except a non-resident alien not engaged in trade or business in the Philippines) whose gross annual income derived solely from salaries and other compensation for services does not exceed his personal exemption of ₱ 1,800 if he is single, or ₱ 3,000 if he is married or head of the family plus the optional standard deduction to which he is entitled.

*Reason for change*

To minimize the administrative work and cost of processing non-revenue income tax returns and to do away with the inconvenience of filing unnecessary returns on the part of individual taxpayers concerned.

### o) Change in corporate income tax declaration and payment

*Prior law*

For each of the first three quarters of its taxable year, a corporate taxpayer is required to file a quarterly summary declaration of its gross income and deductions and pay the tax thereon. After the end of its taxable year, the corporation shall file a final return for the entire year and claim the quarterly tax payments as tax credits against the final tax. If there is an overpayment of tax, it has to file a claim for tax refund or credit. The corporation could not offset automatically any excess tax paid against its quarterly income tax liabilities for the quarters of the succeeding taxable year. Under this system, each quarter was treated as a distinct taxable period so that a corporation could not offset a net loss incurred in one quarter against the net income of another quarter of the same taxable year. The result was that the Bureau of Internal Revenue was flooded with claims for tax refunds or credits.

*Present law*

Section 85 of the Tax Code of 1977 modified the system of corporate quarterly declaration and payment of income tax by permitting the corporation to file its estimated quarterly income tax returns on a cumulative basis. Thus, any net income or loss sustained in one quarter can be applied against the loss or income of the succeeding taxable quarters of the same taxable year.

Additionally and as a corollary to this change, Section 87 grants to corporations the privilege of offsetting or crediting automatically any refundable income tax shown in its final return against the corporate quarterly income tax liabilities for the taxable quarters of the succeeding taxable year.

*Reason for change*

To make tax compliance more simple and convenient for the taxpayer and less costly for the government. The new system will greatly minimize the filing of claims for tax refunds or credits and the administrative work and costs incident to their processing.

**p) Re-definition of a "non-resident citizen" of the Philippines**

*Prior law*

Preferential income tax rates of 1 percent, 2 percent and 3 percent are imposed on the foreign-source income of a non-resident citizen of the Philippines. Section 20(e) of the Tax Code of 1977 defined such citizen to be one who was physically present abroad for an uninterrupted period which included an entire taxable year.

*Present law*

PD 1457 amended Section 20(e) by redefining a "non-resident citizen" as one who establishes the fact of his physical presence abroad with a definite intention to reside therein.

**q) Dividends received by a private educational institution**

*Prior law*

Dividends received by a private educational institution, whether stock or non-stock, from a domestic or resident foreign corporation were subject to a final withholding tax of 10 percent.

*Present law*

PD 1457 amended Section 24(a) of the Tax Code of 1977 by excluding from the dividends subject to the 10 percent final tax those received from a resident foreign corporation. Such dividends shall now be included as part of the gross taxable income of an educational institution against which deductions may be taken and the net income subjected to a 10 percent tax.

**r) Rentals payable to non-resident lessors**

*Prior law*

Gross rentals, charters and other fees paid to non-resident corporate lessors of aircraft, machinery and other equipment for use in the Philippines were subject to a 35 percent withholding tax.

*Present law*

PD 1457 added a new subsection (Section 24(b) (l) (vii) of the Tax Code of 1977) by subjecting such rentals to a final withholding tax of not less than 5 percent nor more than 10 percent to be fixed by the President upon the recommendation of the Minister of Finance. However, until such time as the President shall have prescribed a rate, the tax rate shall be 7.5 percent.

**s) Income of tax-exempt organizations**

*Prior law*

Section 27 of the Tax Code of 1977 enumerates certain organizations not organized for profit which are exempt from income tax like agricultural and horticultural organizations, fraternal beneficiary societies, cemetery companies, business and civic leagues, social clubs, etc. Section 27(e) also considers as a tax-exempt organization one which is organized exclusively for religious, charitable, scientific, athletic or cultural purposes or for the rehabilitation of veterans, except that it contains a qualifying clause that the income of such organization from any of its properties, real or personal, or from any activity conducted for profit regardless of the disposition of the income, shall be subject to tax. This excepting clause did not qualify the exemption of the other listed tax-exempt organizations.

*Present law*

PD 1457 amended Section 27 by making the above qualifying clause applicable to all the exempt organizations enumerated in Section 27.

**t) Deductibility of entertainment expenses**

*Prior law*

Ordinary and necessary entertainment expenses paid or incurred in carrying on a trade or business were deductible.

*Present law*

PD 1457 limited the right of certain individual taxpayers to claim entertainment expenses. If a taxpayer is an individual receiving compensation income, the maximum amount of ordinary and necessary trade or business entertainment expenses deductible from his compensation shall not exceed 10 percent of such income. Compensation income means all remunerations, whether in cash or in kind, for services performed by an employee for his employer.

**u) Deductibility of interest**

*1) Prior law*

Section 30(b) (l) of the Tax Code of 1977 allowed as a deduction "interest paid within the taxable year on indebtedness, . . .".

*Present law*

PD 1457 amended Section 30(b) (l) by inserting the words "or accrued" between "paid" and "within".

*2. Prior law*

A cash basis individual taxpayer could claim as deductions interest paid in advance during the taxable year. Likewise, interest on bona fide loans between related taxpayers was generally deductible.

*Present law*

PD 1457 curtailed the right of individual taxpayers to claim interest deductions. Interest paid in advance through discount or otherwise by a cash basis individual taxpayer can be deducted only in the year the indebtedness is paid except that if the indebtedness is amortized, the interest corresponding to the principal amortized or paid during the year is deductible. Interest paid to related persons enumerated in Section 31(b) of the Tax Code of 1977, such as the taxpayer's lineal descendants or ascendants or his 50 percent-owned corporation, is not deductible.

### v) Foreign tax credit of a partner

*Prior law*

Section 30(c) (3) (C) of the Tax Code of 1977 allowed an individual who is a member of a partnership to take a tax credit for his proportionate share of the foreign income taxes paid or accrued by the partnership without qualifying the nature of the partnership. This was somewhat inconsistent with the other provisions of the Tax Code which treat partnerships, no matter how created or organized, as corporations except general professional partnerships.

*Present law*

To harmonize the wordings of Section 30(c) (3) (C) with the present tax treatment of partnerships, PD 1457 specifically limited the application of the said section to a member of a general professional partnership.

### w) Rentals and royalties derived from Philippine sources

*Prior law*

Rentals from property located in the Philippines or royalties for the use in the Philippines of copyrights, patents, trademarks, secret processes and other intellectual properties are Philippine-source income. On the other hand, technical service fees were generally considered as foreign-source income if the services were performed abroad unless the technical know-how furnished was in the nature of secret processes and the like.

*Present law*

PD 1457 amended Section 37(a) (4) of the Tax Code by expanding the scope of what are considered as rentals and royalties derived from Philippine sources. They now include amounts paid for the following:

1. The right to use in the Philippines any industrial, commercial or scientific equipment.
2. The supply of scientific, technical, industrial or commercial knowledge or information.
3. The supply of any assistance that is ancillary to, and is furnished as a means of enabling the enjoyment of, any such patent or other intellectual property or any such equipment mentioned in No. 1 or any such knowledge or information mentioned in No. 2.
4. The supply of services by a non-resident person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any brand, machinery or other apparatus purchased from, such non-resident person.
5. Any other amount paid for technical advice or services in connection with technical management or administration of any scientific, industrial or commercial undertaking.
6. The right to use motion picture films; films or video tapes for use in connection with television; or tapes for use in connection with radio broadcasting.

### x) Gains from sale of shares of stock

*Prior law*

A non-resident alien or a foreign corporation is taxed only on Philippine-source income. *In Collector of Internal Revenue vs. Anglo-California National Bank*, G.R. No. L-12476, January 29, 1960, the Philippine Supreme Court, construing Section 37(e) of the Tax Code, held that gain from the sale of shares of stock of a Philippine corporation was foreign-source income if the sale was consummated abroad. A sale is consummated when title passes from the seller to the buyer which is usually by delivery. Hence, such gain was not taxable in the hands of a seller who was a non-resident alien or a foreign corporation.

*Present law*

PD 1457 amended Section 37(e) of the Tax Code of 1977 by providing that gain from the sale of shares of stock of a Philippine corporation shall be treated as derived entirely from Philippine sources irrespective of the place of sale. PD 1457 in effect overruled the *Anglo-California National Bank* decision.

### y) Dividends as personal holding company income

*Prior law*

Section 65(a) of the Tax Code of 1977 considered as personal holding company income dividends except those subject to the 10 percent final tax under Section 24(c) of the Code (dividends received by a domestic corporation from another domestic corporation).

*Present law*

PD 1457 amended Section 65(a) by deleting the above excepting clause.

## B. ESTATE TAX

### a) Revocable presumption of life insurance proceeds

*Prior law*

Life insurance proceeds payable to the beneficiary other than the estate of the decedent (the insured), his executor or administrator, were not deemed part of the decedent's gross estate and, therefore, not subject to the estate tax unless the insured retained the power to change or revoke the beneficiary. The presumption was that the designation of the beneficiary was irrevocable.

*Present law*

Section 100(e) of the Tax Code of 1977 changed the presumption. In order that proceeds of life insurance may be excluded from the gross estate of the decedent, the designation of the beneficiary in the insurance policy must be irrevocable. The presumption is now that the designation of the beneficiary in the policy is revocable, unless otherwise specifically provided.

### b) Expansion of the taxable gross estate

*Prior law*

Real property situated outside the Philippines was excludible from the gross estate of a decedent who was a resident or a citizen of the Philippines. In the case of a decedent who was an alien and a non-resident of the Philippines, only that part of his gross estate situated in the Philippines was taxable. There were no provisions for a tax credit for foreign estate taxes.

*Present law*

PD 1457 amended Section 100 of the Tax Code of 1977 by including in the gross estate of a decedent who is a resident or citizen of the Philippines all his real properties even if situated outside the Philippines. The taxable gross estate of a decedent who is an alien and a non-resident remains the same. As a logical consequence of the inclusion of real property located abroad in the gross estate of a deceased, PD 1457 inserted a new subsection (Section 101(e)) allowing a tax credit for foreign estate taxes paid, subject to the "per country" and "overall" limitations.

### c) Joint accounts

*Prior law*

Banks usually honor withdrawal slips signed by one of the joint account depositors.

*Present law*

PD 1457 added a new paragraph to Section 118 of the Tax Code of 1977 by providing that if a bank has knowledge of the death of a joint account depositor, it shall not allow any withdrawal by the surviving depositor unless the Commissioner of Internal Revenue has certified that the estate taxes have been paid. As a corollary thereto, PD 1457 imposes a fine or imprisonment in case any person allows the withdrawal of deposits or investments subject to estate taxes without a certification from the Commissioner that such taxes have been paid.

## C. GIFT TAX

### Expansion of the term "gift"

*Prior law*

For gift tax purposes, a "gift" made by a resident of the Philippines includes real estate and tangible personal properties, if located in the Philippines, and intangible personal property, wherever located. There was no tax credit for foreign gift taxes.

*Present law*

A taxable "gift" made by a resident of the Philippines now includes all real and personal properties, whether tangible or intangible, wherever situated (Section 133 of the Tax Code of 1977, as amended by PD 1457). As a corollary thereto, a tax credit for foreign gift taxes is now allowed subject to the "per country" and "overall" limitations (Section 123-A, Tax Code of 1977 as amended by PD 1457).

## D. SPECIFIC TAXES

### a) Reciprocal exemption from specific tax of petroleum products sold to international carriers

*Prior laws*

Oil products sold to international carriers were subject to specific tax.

*Present law*

PD 1359, effective April 21, 1978, amended Section 134 of the Tax Code of 1977 by exempting from specific tax petroleum products sold to an international carrier for its use or consumption outside of the Philippines provided that the country of said carrier exempts from tax petroleum products sold to Philippine carriers.

*Reason for change*

The amendment is intended as a tax reciprocity.

### b) Increase in specific tax on alcoholic beverages

The Tax Code of 1977 also incorporated the provisions of PD 1155 as Sections 145, 146 and 147 increasing the specific tax on distilled spirits, imported wines and domestic fermented liquor.
The Tax Code of 1977 also restored an old provision, inadvertently deleted in a previous amendatory decree, which would enhance the effectiveness of collecting the specific tax on alcohol. The specific tax on alcohol shall now attach to the substance as soon as it comes into existence. Thus, losses due to handling, excessive evaporation, etc., shall not reduce the taxable base.

*Reason for change*

To raise revenues.

### c) Lifting of restrictions on registration and manufacture of native-type cigarettes

*Prior law*

Cigarettes were required to be packed in packs of either 20 or 30. If 30, they were required to be packed in round shapes only. This restriction acted as a constraint to local manufacturers to promote the saleability of their products by using more attractive and convenient containers for the cigarettes. Also prohibited was the manufacture of new brands of cigarettes if packed in 30's.

*Present law*

The Tax Code of 1977 lifted the above restrictions.

*Reason for change*

The above restrictions are needless.

#### d) Power of President to increase specific tax

*Prior law*

No power.

*Present law*

PD 1393, effective May 31, 1978, inserted Section 158-A to the Tax Code of 1977 granting the President, upon recommendation of the Minister of Finance and the National Economic and Development Authority and after public hearing, the power to revise the rates of specific tax under certain conditions, one of which is that the existing rates may not be increased by more than 50 percent nor decreased by more than 10 percent.

*Reason for amendment*

To give flexibility to the tax system in responding to rapid changes in the economic, social and political environment.

#### e) Specific tax surchange

*Prior law*

Generally, specific taxes on domestic products shall be paid before their removal from place of production. While there were penalties for removal of the products without payment of the tax, no surcharge was imposed unless the goods removed were petroleum products.

*Present law*

PD 1457 amended Section 135 of the Tax Code of 1977 by adding a new paragraph imposing a surcharge of 25 percent of the tax due plus interest of 14 percent per annum if the specific tax is not paid before removal of the domestic products. The same 25 percent surcharge and 14 percent interest are imposed in case the specific tax on imported materials has not been paid (Section 136). Likewise, failure to pay a deficiency specific tax assessment within the time prescribed will result in a 25 percent surcharge plus 14 percent interest per annum (Section 160).

### E. BUSINESS TAXES

#### a) Increase of fixed tax on dealers of locally-purchased products

*Present law*

The graduated fixed annual tax on dealers of locally-purchased products ranged from ₱ 10 to a maximum of ₱ 8,125 depending upon the gross sales of the preceding year. The Tax Code of 1977 increased the rates from a minimum of ₱ 20 to ₱ 38,000 for sales not exceeding ₱ 10 million. For every ₱ 1 million of gross sales in excess of ₱ 10 million, an additional tax of ₱ 1,000 is imposed. The annual fixed tax on persons subject to percentage tax was increased from ₱ 50 to ₱ 100.

*Present law*

PD 1457 amended Section 192 of the Tax Code of 1977 by putting a ceiling on the graduated fixed tax on dealers at ₱ 50,000. PD 1457 likewise increased the fixed annual tax on taxpayers engaged in certain kinds of business like real estate dealers, dealers in securities, lending investors, etc.

#### b) Changes in the sales tax system

PDs 1357 and 1358 restructured the advance and manufacturer's sales tax system (sometimes referred to as percentage sales tax) covered by Title V of the Tax Code of 1977.

PDs 1357 and 1358 took effect on April 21, 1978. However, their provisions relating to the payment of the quarterly percentage tax on sales were effective beginning July 1, 1978.

The salient changes are as follows:

1. Before PD 1358, the basis for computing the advance sales tax on articles imported for resale or to be used in the manufacture of products for sale is the total landed cost plus the corresponding mark-up. Landed cost means the invoice value plus postage, freight, insurance, commission, customs duty and all other similar charges incurred by the importer before the release of the goods from customs custody. Now, the basis for computing the advance sales tax is the home consumption value plus 10 percent thereof (which is similar to the base for computing customs duty) plus postage, commission, customs duty and similar charges incurred prior to release of the goods from customs custody, but excluding freight and insurance, plus the corresponding mark-up. There was no change in the mark-up rate.

2. Certain articles which were previously classified as either luxury, semi-luxury and ordinary items are now reclassified either as non-essential, semi-essential, ordinary, and essential articles. For example, locally-manufactured medicine and laundry soaps and detergents considered previously as ordinary items are now reclassified as essentials.

3. The taxable rate on non-essential articles was reduced from 70 to 50 percent and on semi-essentials from 40 to 25 percent. The rate on ordinary articles was, however, increased from 7 to 10 percent. The rate on essentials remains at 5 percent.

4. PD 1358 eliminated the preferential tax treatment accorded to semi-luxury items "locally manufactured" by "integrated or non-integrated" manufacturing establishments. Previously, semi-luxury articles locally manufactured by a non-integrated manufacturer were taxed at 15 percent and by an integrated manufacturer at 7 percent. Now, these articles are subject to sales tax ranging from 10 to 25 percent, depending on the selling price thereof. The selling price of most of these articles falls within the maximum bracket of 25 percent so that for an integrated manufacturer of semi-luxury items, there is an increase of 18 percent in the tax rate.

5. Defore, producers of agricultural food and non-food products were not subject to the percentage sales tax. Now, such products are subject to a tax of 1 percent of gross selling price.

6. PD 1358 empowers the Minister of Finance upon the recommendation of the Commissioner of Internal

Revenue to impose the same rate of sales tax on articles which are similar or analogous to the articles enumerated under Section 194 (non-essentials), 196 (semi-essentials) and 197 (certain semi-essentials) on the basis of their inherent essentialities. Under PD 1457, such power is without prejudice to the authority of the Commissioner of Internal Revenue to issue rulings on the classification of articles for sales tax and similar purposes.

7. PD 1358 as amended further by PD 1393 effective May 31, 1978 revised Section 193(c) of the Tax Code of 1977. In addition to the powers granted to the President under certain conditions to revise the rates of percentage taxes and to change the classification of articles enumerated in Sections 194 (non-essentials), 195 (cars), 196 (semi-essentials), 197 (certain semi-essentials), 198 (agricultural products), 199 (ordinary articles) and 201 (essentials), the flexibility clause of Section 193(c) has been expanded to include the power to revise the taxable base levels in Sections 195 and 197. The existing tax rates may be increased by not more than 50 percent nor decreased by more than 10 percent, and the existing price levels increased or decreased by not more than 50 percent.

8. PD 1358 added Section 193(d) of the Tax Code of 1977 granting the President, upon recommendation of the Minister of Finance, the power to subject the second sale of any article subject to percentage tax at the same rates as provided in the respective sections to a *value-added tax* based on the gross selling price or gross value of any of the articles transferred or exchanged.

9. In computing the sales tax, PD 1358 adopted the system of tax credit in lieu of the cost of raw material deduction method. Before, in arriving at the tax base of the percentage sales tax, the cost of the raw materials, under the same section of the Tax Code to which finished products are subject, could be deducted from the gross selling price. Now, the percentage tax on sales is computed by multiplying the gross selling price by the applicable tax rate and claiming as tax credit any specific tax, percentage tax, or mining tax paid under Titles IV, V or VII of the Tax Code of 1977, respectively, on domestically manufactured, processed or produced, or imported raw materials, parts, accessories or other articles forming part of the finished products sold. The excess can be credited against the sales tax liabilities for the succeeding taxable quarters. To claim the tax on raw materials as a credit, it should be indicated as a separate item in the sales invoice.

10. As a corollary to the tax credit method, Section 200 of the Tax Code of 1977 was amended in that whenever a tax-exempt product is used as a raw material, the percentage tax, specific tax or mining tax otherwise due on such product can be claimed as a credit against the sales tax on the finished product.

11. PD 1358 amended Section 202 of the Tax Code of 1977 by withdrawing the percentage tax exemption granted to certain taxpayers (usually persons whose gross monthly or daily sales do not exceed a certain amount). However, PD 1469 which took effect on June 11, 1978 enlarged the scope of Section 202 by exempting from sales tax the so-called "indirect exports", that is, sales in the Philippines by a registered export producer to another registered export producer, registered export trader or foreign tourists. Before PD 1469, domestic sales by a producer to a person who actually exports the products were subject to the percentage sales tax. The export producer must be registered with the Philippine Export Council. PD 1469 is intended to encourage producers who lacked the necessary export facilities and skills to sell to registered export traders.

12. PD 1357 amended Section 195 of the Tax Code by providing a new basis for computing the manufacturer's sales tax on the sale of automobiles locally assembled. Under the amendment, the sales tax shall be based on either the "suggested retail or list price" or "the actual retail price", whichever is higher. Before the amendment, the basis of the tax was the gross selling price of the manufacturers to the dealers. Thus, various schemes were adopted by a manufacturer in reducing the gross selling price of automobiles to its dealers particularly in instances where the dealers were controlled one way or another by the manufacturers or stockholders thereof. PD 1359 is a response to such schemes.

To minimize any possible arrangement between the manufacturer and dealer, the suggested retail or list price shall in no case be less than 15 percent over and above the selling price of the assembler to the dealer, or not less than 30 percent over and above the manufacturing cost, in case of direct sales to the public by the assemblers. The tax rates were also revised. The meaning of the "sale of an automobile" was also expanded.

*Reason for changes*

To raise revenues and to simplify the administration of the sales tax system.

### c) Transaction tax on commercial papers issued in the primary market as principal instruments

*Prior law*

Interest earnings on money market placements were reportable and taxed accordingly. However, due to the complexity of money market operations, tax authorities found it difficult to trace the interest earners so that is was possible that a substantial amount of this type of income went untaxed.

*Present law*

The Tax Code of 1977 incorporated as Section 209(b) PD 1154, effective June 3, 1977, which imposes a final transaction tax of 35 percent on the gross interest paid on commercial papers issued in the primary market as principal instruments. The tax is payable by the borrower (limited to corporate issuers), not the lender, within five working days from the issuance of the commercial paper. The 35 percent tax is deductible by the borrower from its gross income but the interest earner need not declare his interest earnings as part of his gross income for income taxation.

*Reason for change*

PD 1154 is not really a new tax measure but is intended to improve the tax collection for this type of income considering that the Bureau of Internal Revenue had previously no practical means of enforcing strictly the taxation of interest income on money market transactions. For convenience, it was deemed proper to have the borrower shoulder the tax instead of acting merely as a withholding agent.

**d) Changes in compensating tax**

PD 1457 made changes in the compensating tax system (Section 204 of the Tax Code of 1977) to conform to the amendments introduced by PDs 1358 and 1395.

The salient changes are as follows:

1. Before PD 1457, the basis for computing the compensating tax was the landed cost of the imported articles but without the corresponding mark-up. The term "landed cost" was the same used in computing the advance sales tax before the method was changed by PD 1358. PD 1358, however, failed to change the method of computing the compensating tax. PD 1457 now corrects the oversight by providing that the basis for computing the compensating tax is the same used for the advance sales tax but without the mark-up.

2. In the case of imported automobiles, a new schedule of tax rates is fixed ranging from 100 percent of the landed cost to ₱ 57,500 if the landed cost exceeds ₱ 50,000, plus 200 percent of the excess.

3. Articles enumerated as exempt from compensating tax under Section 204 continue to enjoy such exemption without prejudice to PD 1395 (please refer to I) which imposes a 5 percent duty and 5 percent internal revenue tax on importations of articles which are at present fully or partially exempt. In other words, if the importation is one of those excluded by PD 1395, it will continue to be exempt from compensating tax; otherwise, it will be subject to a 5 percent compensating tax.

4. If any article withdrawn from customs custody without the payment of the compensating tax shall, within one year from date of withdrawal, be used by the importer for other purposes or sold, the proper taxes must be paid within 10 days from such use or diversion. In case of delinquency, a surcharge of 25 percent plus interest of 14 percent per annum are imposed.

**e) Changes in independent contractor's tax**

*1) Prior law*

Section 205 of the Tax Code of 1977 imposes a tax of 3 percent on the gross receipts of independent contractors. Excluded by Section 205 (16) from the 3 percent tax are gross receipts of contractors received from a pioneer enterprise registered under the Investment Incentives Act (RA 5186 as amended) and of contractors under contracts of embroidery and apparel for export.

*Present law*

PD 1457 amended Section 205 (16) by subjecting the gross receipts of above contractors to the 3 percent tax. The Decree also expressly considered security agencies as contractors subject to the 3 percent tax.

*2) Prior law*

In determining the "gross receipts" of a contractor subject to the 3 percent tax, that portion of the contract price paid by the contractor to a subcontractor shall be deducted. However, the subcontract price paid shall form part of the gross receipts of the subcontractor.

*Present law*

PD 1457 amended Section 205 by making the primary contractor responsible for the 3 percent tax on the total contract price. The taxable gross receipts mean the total contract price received by the principal contractor undiminished by amounts paid to a subcontractor. However, the subcontract price paid to a subcontractor shall be excluded from the latter's gross receipts.

**f) 2 percent carrier's tax**

PD 1457 amended Section 207 of the Tax Code of 1977 which imposes a 2 percent tax on carriers by increasing the minimum taxable gross quarterly receipts of land carriers.

**g) Stock transaction tax of ¼ of 1 percent**

*Prior law*

Section 210 of the Tax Code of 1977 imposes a tax of ¼ of 1 percent on the sale or transfer of shares of stock acquired on or after November 5, 1970, based on the gross selling price or gross value in money. However, any capital gain arising from the stock transfer is exempt from income tax. Under Section 35(c) (2), no gain or loss shall be recognized if a person exchanges his property for stock in a corporation of which, as a result thereof, the transferor (alone or together with not more than four other persons) gains 51 percent of the voting stock of the transferee corporation. The gain of the transferor is deferred until eventual disposition of the stocks. If the transferor should later sell the stocks acquired in the exchange, there was some uncertainty as to whether or not the transferor by paying the ¼ of 1 percent tax would be exempt from income tax on the capital gains which went unrecognized in the initial transfer. However, the Bureau of Internal Revenue considered such capital gains as subject to income tax.

*Present law*

The above problem has been definitely settled by PD 1457 amending Section 210. Capital gains from a sale or exchange of shares of stock acquired by a person in an exchange where no gain or loss was recognized are subject to income tax.

## F. DOCUMENTARY STAMP TAX

**Changes in stamp tax**

*Prior law*

A documentary stamp tax was imposed upon certain instruments and papers. A science stamp tax equivalent to

100 percent of the documentary stamp was likewise levied.

*Present law*

PD 1457 eliminated the science stamp and imposed only the documentary stamp tax. However, the rates were increased.

## G. MISCELLANEOUS TAXES

### Tax on overseas communications

PD 1457 inserted a new Section 290-A to the Tax Code of 1977 by imposing a tax of 10 percent on the amount paid for overseas dispatch, message or communication transmitted from the Philippines by telephone, telex, cable and other communication equipment services, to be paid by the payor for the services. Before, there was no such tax.

## H. TAX ADMINISTRATION

### a) Power of the Commissioner of Internal Revenue to issue assessments

*Prior law*

When the Commissioner of Internal Revenue had reason to believe that a report was false, incomplete or erroneous, he could assess the proper tax on the best evidence obtainable.

*Present law*

PD 1356, which took effect March 21, 1978, amended Section 16 of the Tax Code of 1977, giving the Commissioner of Internal Revenue the added authority of placing taxpayers under surveillance for two months, if there are reasons to believe that such person is not declaring his correct income and receipts. The findings for this period may be used as a basis for a tax assessment for the other months of the same or different taxable years and such assessment shall be considered prima facie correct.

*Reason*

In a number of cases (Collector of Internal Revenue vs. Benipayo, G.R. No. L-13656, January 31, 1962; Viterbo vs. Collector of Internal Revenue, CTA Case No. 363, December 26, 1958; Samson vs. Collector of Internal Revenue, CTA Case No. 232, June 30, 1958), assessments by the Commissioner of Internal Revenue based on estimates and observations were repeatedly rejected by the Philippine courts. PD 1356, which is intended to reinforce tax administration, appears to be the legislative response to the above decisions. Certain safeguards are, however, being taken to prevent an abuse of this authority.

### b) Authority of the Secretary of Finance to require withholding of creditable income taxes from certain income payments

*Prior law*

Section 53(f) of the Tax Code of 1977 authorized the President, upon the recommendation of the Minister of Finance, to subject to a withholding tax of 10 percent certain items of income of residents.

*Present law*

Section 53(f) was amended by PD 1351, effective April 17, 1978, by providing that the Secretary of Finance may, upon recommendation of the Commissioner of Internal Revenue, require the withholding of a tax on certain fixed or determinable income or capital gains payable to resident taxpayers at a rate of not less than 2.5 percent nor more than 35 percent thereof, which shall be credited against the final income tax liability of the taxpayer for the taxable year. So far, the Secretary of Finance has not formally come out with regulations specifying the items of gross income subject to withholding under this section. To strengthen Section 53(f), PD 1351 also provides that any income payment which is otherwise deductible from gross income can be deducted only if the withholding tax thereon has been paid to the Bureau of Internal Revenue.

*Reason for change*

PD 1351 is a measure intended to strengthen the effectiveness of the present tax collection system and to help the Government's cash flow. It reveals the intent of the Government to broaden the coverage of the withholding tax system.

### c) Authority to examine the accounting records of tax-exempt organizations

*Prior law*

There was some dispute as to the authority of the Commissioner of Internal Revenue to examine the accounting records of tax-exempt entities which were not subject to internal revenue taxes.

*Present law*

PD 1457 has specifically granted such power to the Commissioner.

## I. TAX PRIVILEGES

### Repeal of duty and/or tax-free importation privilege

*Prior law*

Under various incentive and special laws, certain taxpayers enjoyed the privilege of duty and tax-free importation.

*Present law*

PD 1395 (which amended PD 1352 on the same subject), effective May 31, 1978, repealed such privilege. Now, all importations which are at present totally or partially exempt under the provisions of any general or special law shall be subject to a 5 percent customs duty and 5 percent internal revenue tax. Among the notable laws affected by this repeal are the Investment Incentives Act (RA 5186 as amended) and Export Incentives Act (RA 6135 as amended), although importations for projects already approved as of April 21, 1978 by the appropriate government agency may continue to be exempt but in no case beyond December 31, 1981. Duty and tax-free importation privileges enjoyed under international treaties and commitment and those granted under the Export Processing Zone Decree (PD 66), The Oil Exploration and Development Act of 1972 (PDs 87 and 529) and The Coal Development Act of 1976 (PD 972) are not affected.

*Reason*

Under PD 776, a Fiscal Incentives Review Board was created to study and recommend to the President the suspension, revocation or modification of any tax incentive. PD 1395 is in line with the policy of PD 776 to rationalize and harmonize the fiscal incentives granted under various laws for purposes of conserving revenues.

# Current Status of Studies and Work on Tax Treaties LAFTA and Andean Pact Models*

By Dr. Ramón Valdés Costa

This report is aimed at making a critical and comparative analysis of both LAFTA and Andean Pact models and, to remain within our schedule, it must necessarily be synthetic.

## General Considerations

It may be stated that these models represent the most genuine and systematic expression of the traditional Latin American position in this field, which is characterized by the upholding of the principle of source as opposed to those of nationality and domicile.

This position found its first international expression in the Model Convention of Mexico of 1943, which was approved by the Fiscal Committee of the League of Nations at its Second Regional Fiscal Conference where, for rather circumstantial reasons, the Latin American viewpoint predominated. The model was substantially revised at the following meeting held in London in 1945; the approach of developed countries predominated in the international sphere as of that date. Latin American countries defended their legitimate fiscal interests and realized their fiscal policy, applying the principle of source with doubtless coherence and persistence, unilaterally through their domestic legislations.

The growing international expansion of the economy, the appearance of important economic problems concerning transfers of capital and technology which were required by development, and the also important tax problems derived from expansion of transnational companies led to renewed discussion at different forums of the need to structure new model international treaties, in particular with reference to relations between developed and developing countries.

As previously stated, the models which we shall analyze are inspired by the principle of the source but it is necessary to highlight the fact that they are characterized by representing a radical manifestation of same. This characteristic is doubtless of importance in discussion of the topic from the international viewpoint since this radical position has undoubtedly had an influence on the scanty progress observed in understandings with developed countries. The best illustration of this statement is found in the reduced number and minor significance of the treaties entered to date.

On a previous occasion I said that the Andean Pact Model, more than a model treaty, represents a declaration of principle which, due to its rigidity, necessarily leads to serious — not to say insurmountable — difficulties in its application since every treaty necessarily implies solutions representing a conciliation and mutual concessions. This opinion, which has been confirmed with the passing of time, is partially applicable to the formulas recently proposed by LAFTA which are directly based — and this has been expressly recognized — on the solutions adopted by the Andean Models, although they do not offer the same rigidity. Consequently and as a first commentary it may be said that the greatest significance of these documents lies in their systematic vindication of the Latin American position as well as

*Contents*



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in the fact that they represent a starting point for eventual negotiations with developed countries.

A second characteristic of these drafts which is intimately related to the previous one is that of extreme concern for the defense of fiscal interests which, on occasion, even contradicts the basic principle of source — as is the case in the field of technical assistance — and has sometimes sanctioned solutions which are really exceptional in comparative legislation and on the other hand are resisted by doctrine, including Latin American doctrine. In such cases we find a failure to recognize the contractual relations existing between parent companies and their affiliates or subsidiaries, in particular with regard to royalties and technical assistance.

In the third place we should mention that in upholding the principle of source as *exclusive criterion*, and not simply as primary criterion, for the allocation of the power of taxation both drafts implicitly sponsor solutions which on occasion — and with increasing frequency — are contrary to the legitimate interests of developing countries. I am referring to the possibility of taxing under certain conditions, and within the sphere of progressive overall income tax, the income earned abroad by the nationals of Latin American countries: a solution which is not only convenient from the fiscal standpoint but also recommended by the best tax techniques and having doubtless economic projections in the removal of capital from the area.

Fourthly, certain omissions must be pointed out. The first of these omissions, due to its importance at least in the field of treaties between developed and developing countries, is the one concerning incentives to the flow of capital, technology and technical assistance. Of course the absence of provisions in this regard finds its explanation in the adoption of the principle of source as exclusive criterion for taxation, a solution which could place developing countries in a situation of total freedom to adopt the incentive policies they consider best suited to their interests; but, as is obvious, this explanation would only be valid in the practically impossible hypothesis of developed countries integrally accepting the entering of treaties under these conditions.

Another less transcendant omission but one which is undoubtedly important from the practical standpoint is that concerning determination of net taxable income, particularly in regard to royalties and interest.

### General characteristics of the texts

As is widely known, Decision 40 of the Cartagena Agreement, adopted at the Seventh Regular Session held in Lima in November 1971, approved two Conventions: one to avoid double taxation in member countries and a "Model-Convention to avoid double taxation between member countries and other states outside the subregion". Both refer to income and net-worth taxes and offer substantially the same solutions.

The work accomplished by LAFTA in this field through its three meetings of experts on international double taxation, has, to the date of preparation of this report, been made explicit in valuable technical studies prepared by the Secretariat which will be discussed by the Fourth Meeting to take place 15-20 August of this year. Thanks to the spirit of cooperation shown by the head of this Secretariat we have had this material available for the preparation of the report. In this respect we shall principally take into consideration document LAFTA/DTI/IV/dt2 entitled "Technical criteria applicable to the allocation of the power of taxation in Conventions entered between LAFTA countries". Notwithstanding the limitation involved in this very title, it must be remembered that, as is stated in the Secretariat report, "The studies made are based on the criteria which, with reference to negotiations that could be conducted by member countries with third countries, were defined and ratified" by the respective meetings of Directors of Internal Taxes held in 1973, 1975 and 1976. These criteria which are applicable to negotiations between LAFTA countries and third countries have been defined and commented upon in document LAFTA/DTI/IV/di2 of 11 February 1977, which has also been particularly taken into consideration in this report. [1]

From the formal standpoint both drafts offer the structure of a model bilateral treaty, but they do present clear differences.

The Andean Pact Draft is a concrete and official manifestation of countries within the subregion which was the result of studies on this subject with a precise background in Decision No. 24 establishing economic policy vis-à-vis foreign investment. Consequently, it must be seen as a definite stand taken by that group of countries.

The documents prepared by LAFTA are, instead, only a concrete formulation of studies made to date which have not received a final approval of member countries, among other reasons due to the diversity of opinions sustained by the different countries on problems of great importance, as well as to the evolution of the ideas predominating within each country in particular. An example of the first case is that of the formulation of the concept of source and, in particular, the new concept of source conceived through the criterion known as "paying source" and, as an example of internal evolution, the changes observed in the tax treatment applicable to transactions between related companies.

These characteristics of LAFTA work to explain the fact that the technical criteria proposed to the Fourth Meeting of Experts on controversial aspects present the form of alternative or optional solutions, limited to the scope of LAFTA countries. [2]

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1. The meeting was held with the participation of Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, Mexico, Paraguay, Uruguay and Venezuela. Also present were representatives of the following international organizations: IDB, INTAL, OAS, IFA and CIET.
The final report offers very minor differences with the previously cited Technical Reports of the Secretariat, and almost all of them are of a formal character.
The most important are attached as footnotes to this report.
2. In the Final Report of the IV Meeting relevance was given to "the technical nature of the bases for harmonization to be defined through the tasks entrusted to the experts, as well as

The solutions regarding third countries have been somewhat left aside, since the Experts have considered that "in the current stages LAFTA is going through, it is not necessary to define any single criterion since, until the decisions to accomplish harmonization are made, the Contracting Parties must continue to adjust any tax treaties entered to the solutions set forth under their legislations". Consequently — the Secretariat report states — (the Experts) limited themselves to "establishing the most adequate alternatives, taking into consideration both their technical bases and their behavior vis-à-vis the interests of countries in the area" (Doc. LAFTA/DTI/IV/di2, p. 7).

## Comparative analysis of treaty articles

*Substance of the Convention* (Art. 1 of A.P. and Art. 1 of LAFTA)

Both articles similarly provide for the enumeration of the taxes to which they will be applied, clarifying the elasticity in their scope by including amendments to existing taxes and to those to be established in future, provided they are essentially and economically analogous to those expressly mentioned (A.P.) or of identical or analogous nature (LAFTA).

The LAFTA norm also determines the scope of income tax, comprising over-all income tax, those taxes levied on specific types of income, as well as those levied on capital gains. It also states that net worth taxes are considered to be both those applicable to the over-all net worth as well as those levied on elements of same.

*General Definitions* (Art. 2 of A.P. and Art. 2 of LAFTA)

These articles contain the traditional definition of Contracting States, Member States, territory and persons, given in very similar terms. With reference to the concept of "person" it is worth highlighting an innovation offered by the LAFTA articles in recognizing, as such, branches, agencies or any other type of similar establishment that a company domiciled outside the territory of one of the Contracting States has in same. These establishments — comments the Secretariat — do not have their own legal status nor do they represent a commercial entity different to the parent company. This is a useful norm because it clarifies that these entities are in themselves subject to taxation. The same solution could be reached through an interpretation of Art. 2, paragraph C) No. 3 of the A.P. Model, also reproduced by LAFTA, which recognizes as a person "any other entity or group of related or not related persons, which are subject to taxation". Thus both provisions reflect the most widely admitted doctrine in contemporary Tax Law which was incorporated in the Model Tax Code for Latin America and in the National Tax Codes it inspired.

The following articles coincide in the definition of the terms "producing source" and "enterprise". With reference to the latter it may be added that the LAFTA definition complements the A.P. definition by establishing the joint application of capital and labor as integral elements of the concept. [3]

*Chapter II — Income Tax*

*Tax Jurisdiction* (Art. 4 of A.P. and Art. 4 of LAFTA)

Through different draftings, the jurisdiction is determined by means of the location of the source generating the income. This concept is defined by the Andean Pact as the activity, right or goods generating, or which may generate, income; and by LAFTA as the tangible or intangible capital generating it. Although a systematic interpretation of the different norms established by these Models would provide a clear understanding of the meaning of the provisions we are analyzing, their wording if taken in an isolated manner could lead to confusion, e.g. with regard to royalties. The standard would have gained much precision if it had been directly said that the income subject to the Treaty is the income derived from activities developed, goods located or rights used for economic purposes within the country of taxation.

*Income from Real Estate* (Art. 5 of A.P. and Art. 5 of LAFTA)

Both reflect the traditional solution which has not been disputed by comparative legislation, that this income must be taxed in the country where the goods generating it are located. As a supplement, Art. 6 of A.P. refers to income derived from the right to exploit natural resources; this must be considered equivalent to the addition made under Art. 5 of the LAFTA draft considering as included within this category the income derived from agricultural and livestock farming concerns, forestry and mineral extraction, as well as any payments received for any type of use or exploitation of real estate.

*Corporate Profits* (Art. 7 of A.P. and Arts. 14, 16, 17 and 18 of LAFTA)

Three parts can be differentiated within these articles: that concerning the general criterion on location of income, assumptions on its location, and the development of activities in more than one territory.

With reference to the first aspect, the A.P. integrally adopts the traditional concept of source establishing that these profits are only taxable in the state where the corresponding activities have been developed.

The LAFTA Model introduces an important proviso,

to the non-binding character of these tasks which imply collaboration with the Latin American Free Trade Association for the preparation of technical material to support the actions which the Contracting Parties may eventually decide to undertake in the field of tax harmonization; without this in any way representing an interpretation to the effect that the solutions recommended by the experts should represent inflexibility in regard to the power of negotiation of countries in the Area".

3. With reference to *domicile* of individuals, the LAFTA Draft does not adopt a definite position. For the remainder of persons, the IV Meeting opted for the criterion of effective management set forth in the base document adopted by previous Meetings. Addition was also made to this Art. 9, par. d), of the indexes to be used for determining the place of effective management: site or principal headquarters of the business or its actual domicile.

excluding the profits earned by companies engaging in the rendering of personal services mentioned under Art. 21 which, as we shall soon see, establishes three alternative solutions: the place of *payment*, the place of *use* of the services, and the place of the *rendering* of same.

With regard to the assumptions, the A.P. resorted to an original procedure which was afterwards followed by LAFTA. It makes an enumeration of certain types of organization of activities which in developed countries are considered as representing the concept of *"permanent establishment"*. But instead of considering these as an essential requirement to determine the location of the income, the A.P. takes them only as an assumption — in my opinion, an absolute assumption — of that location; notwithstanding the possibility of applying the tax to income derived from other situations or organizations, due to the application of the general principle which, as stated previously, attributes decisive character to the place where activities are developed. The enumeration of the situations to this effect taken into account is different in the two models. The LAFTA draft deleted the four first chapters concerning offices, factories, construction works, mines, quarries, etc. In my opinion this suppression does not alter the sense and scope of the norm. It seems to be founded on a technical-legal reason, with the decision to prefer to limit this enumeration only to doubtful cases which may lead to controversies, a situation which does not seem to arise in the four paragraphs that were eliminated. [4]

The third part of Art. 6 of A.P. agreeing with Art. 16 of LAFTA, refers to the case of development of activities in two Contracting States sustaining the orthodox solution of the principle of source that each one of them may tax the income generated within its territory. Art. 16 of LAFTA which was cited continues in its first part — as is stated in the Secretariat Report — with the criterion normally applied to independent entities, sustaining the system of "separate accounting". However, taking into account the discrepancies observed at previous meetings of Experts, two paragraphs of an optional character were added stating that the State in whose territory the activities are developed is granted the "right to deny expenses applicable to the use of capital or technology owned by the company or to rendering of services supplied by component parts of same". Thus, the treaty itself incorporates the solution which, within the Andean Pact, is derived from application of Decision 24.

Similar solutions are established by LAFTA Art. 17 concerning transactions between *related companies* where, in its first part, the indisputable right of the States to correct balance sheets to the effect of adjusting them to reality, or to establish "the profits that each of the parties would have derived if the relations between them did not exist and which have not been generated due to same", was expressly established. This article also adds an optional paragraph empowering the interested State to "deny the independence" of these companies in order to establish the treatment afforded to payments made between them, although without concrete specification of the concepts for which the payments were made.

Another innovation made by LAFTA is that of Art. 18 in which, reflecting the recommendation made by the Second Meeting of Experts, the Contracting State in which the merchandise remitted from abroad is processed or transformed is granted the right to tax the foreign company on the income generated by that process. This is an original solution finding its solid base in the integral application of the principle of source which, according to traditional Latin American doctrine, does not require for its application the existence of a permanent establishment as is sustained by the doctrine and the Models of developed countries.

*Profits of Air and Sea Carriers* (Art. 8 of A.P. and Art. 19 of LAFTA)

This practically insoluble problem of international tax law finds the usual "exception" solutions in both models. In the A.P. model an alternative is offered to recognize the power of taxation of the State in which the respective enterprises are domiciled and of only taxing the operations conducted in each interested state. Within the LAFTA draft, apart from this solution which is doubtless the most orthodox within the principle of source, the possibility is added of recognizing the power of taxation of the State in whose territory is located the "effective management" of the enterprise, and provides criteria to this effect concerning its location. [5]

*Royalties* (Art. 9 of A.P. and Art. 8 of LAFTA)

The A.P. follows with all precision the orthodox solution, establishing that this income can only be taxed in the territory in which use is made of "trademarks, patents and unpatented knowledge or other intangibles similar in nature". As was the case with interest and technical assistance, opinions within LAFTA differ on this point with reference to the concept of source, principally as a consequence of the appearance of the theory of the "paying source". For this reason the alternative solution is offered of recognizing the power of taxation of the State in whose territory are located or used the goods whose transfer generates income, or of the state from whose jurisdiction payments are made.

Another important difference is the concept of royalties. As is inferred from the enumeration mentioned above, the A.P. resorts to a strict criterion: it only refers to use and not to the definite transfer of these goods, and they are limited to intangibles, in this respect citing the most frequent cases. Instead, the LAFTA draft, although also exclusively referred to utilization — in other words to transfer for use and not to final transfer of the goods — makes a much more extensive enumeration which, as is recognized in the Secretariat Report, is "inspired in the text of the OECD Model Convention". Thus inclusion is made of income for the use or utilization of international news, industrial, commercial and scientific equipment, leasing and know-how. Both drafts

4. The draft submitted to the IV Meeting only contemplated the relations between parent companies and affiliates or subsidiaries. The Experts, with no exceptions, were of the opinion that it was preferable to expand the concept, adapting it to the one given under Art. 9 of the OECD Model.

5. These criteria were incorporated to Art. 2d) which is of a general character.

coincide in the solution — which is correct in my opinion — of not referring to the manner in which payment is agreed upon, since various solutions for this problem have been found in comparative Latin American legislation. [6]

*Interest* (Art. 10 of A.P. and Art. 7 of LAFTA)

As was stated, this problem offers aspects similar to the previous one.

The A.P. definitely opts for the classical solution within the criterion of source, recognizing the exclusive right of the State "in the territory of which the credit is used". Due to the well-known difficulties in locating this fact, it afterwards includes a simple assumption to the effect that the credit is used in the territory "from which interest is paid". The LAFTA draft offers an alternative between this solution and the solution of the place from which payment is made.

With reference to the first formula it might be useful to point out that the LAFTA draft together with the criterion of *utilization* introduces that of *placement*, seemingly treated as synonyms, a synonym which is rather debatable.

We should also highlight that the LAFTA draft has taken a position in the much debated problem of the treatment to be given to interest or over-pricing in the case of sales and operations with deferred payment, a problem which is much discussed in the literature, and to which several solutions have been proposed in comparative legislation whereas the A.P. had avoided taking a position in this respect, although the subject had been especially taken into consideration in the studies made prior to adoption of the Model.

*Dividends and Shares* (Art. 11 of A.P. and Arts. 10 and 11 of LAFTA)

Solutions are clear and inspired by the classical principle of source. Consequently, both drafts assign the power of taxation to the states "where the distributing enterprise is domiciled".

*Income from Personal Services* (Arts. 13 and 14 of A.P. and Arts. 20 and 21 of LAFTA)

The A.P. sustains the classical solution within the principle of source, "establishing that this income is only taxable in the territory in which such services are rendered", and establishing the ususal exemptions concerning official functions and the crews of international carriers. The LAFTA draft situation, on the contrary, is diffuse. The draft proposes three alternatives: the previously mentioned criterion of the place where the services are *utilized* and the territory from which these are *paid*. [7]

It seems timely to highlight that the position sustaining the criterion of the "paying source" is undoubtedly influenced by concerns of a fiscal nature which in recent times have become acute due to the expansion of technical assistance services rendered from abroad. This circumstance disturbs the technical hierarchy and will also have an unfavorable effect on eventual negotiations that could be undertaken with countries in which these activities are developed.

*Net Worth Taxes* (Arts. 17 and 18 of A.P. and Arts. 23 to 34 of LAFTA)

Within the concept of the principle of source, these taxes doubtless offer fewer difficulties than income tax, since the jurisdictional principle is clearly defined by the territorial location of the properties. The concrete solutions offered by the two drafts must be taken as clarifications or precise limitations on this principle.

*General Provisions*

*Inquiries and Information* (Art. 19 of A.P. and Art. 36 of LAFTA)

The provisions are simple and direct and quite general in nature. It may be said that they are limited to providing the bases for a system of inquiries and exchange of information aimed at facilitating enforcement of the treaty: in other words at "solving by mutual agreement any difficulty or doubt which may arise" and at "establishing the administrative controls required to avoid fraud and evasion".

The addition introduced by the LAFTA draft concerning controls over the operations of related companies. or over those of members of a single group, is more of a clarification than a qualification of those principles. It seems useful to note that there are no provisions concerning the manner in which conflicts would be treated between states concerning the scope of their respective powers of taxation, nor with reference to conflicts on double taxation that may arise with reference to taxpayers in each State.

To follow the order of the presentation of the topic formulated by the CIAT Executive Secretariat for this 19th Conference, the following may be pointed out:

1) *Types of Exchange.* These are not specified. General reference is made to the *necessary exchange* to solve any difficulty on the basis of mutual agreement.
2) *Confidentiality.* Both drafts without exception follow the traditional formula of the confidential character of this information. They add that use of the information is limited to "the authorities responsible for the administration of the taxes included in the Convention".

6. At the IV Meeting it was opportunely pointed out that this expansion of the concept of Royalties could be justified in the OECD Model which establishes the exclusive criterion of domicile.

7. At the IV Meeting terminological adjustments were made which are worth mentioning because they clarify concepts. The term "rendering of services" was considered to be doubtful because it contains two elements — development of the activity and utilization of the services — which are those permitting the precise location of the place of taxation. For this reason, alternative 2 refers to the place where the services are utilized, and alternative 3 to the place of development of the activity.

3) *Explaining the grounds for request.* No express provision is made in this respect; however it should be considered as implicitly included in the requirements qualified by the adjective "necessary" mentioned under 1) above.

4) *Administrative procedure.* The A.P. draft provides that for the purposes of this article competent authorities ... "may communicate directly between them". The LAFTA draft, which in previous paragraphs follows the A.P. Art. 19 almost to the letter, omits, seemingly deliberately, this provision.

5) *Specific cases.* The A.P. Model does not include norms to this effect. The LAFTA draft makes a relatively concrete reference in adding the hypothesis of auditing of "the operations made between members of the same enterprise or companies part of the same entrepreneurial group". This express reference to related companies is explained in the report as aimed at "verifying and, when applicable, adjusting the prices and values declared by the parties".

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*Business International Institute/Asia:* Semiar on Regional Business Environments and International Management (subjects include such as country comparisons: taxation), Hong Kong, November 12-17 (English).

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FOR FURTHER INFORMATION PLEASE WRITE TO:

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# CIET

# Review of its training activities[1]

by Prof. Pedro Massone

CONTENTS



## 1. The foundation of CIET

The "Centro Interamericano de Estudios Tributarios" (CIET) is an inter-American center for tax studies located in Buenos Aires, Argentina. It is currently sponsored by the Organization of American States through its Office of Public Finances which is in charge of the implementation of a tax program the general aims of which are "to contribute to the strengthening of the Latin American tax systems, to improve their administration, and to capacitate and train officials" from the tax services and from the agencies establishing the tax policy of member countries.

The activities of the Organization of American States in the field of taxation began in 1960, when a Joint Tax Program was established under the sponsorship of the Organization of American States, the Inter-American Bank for Development and the Economic Commission for Latin America.

In 1963, the Economic Commission for Latin America withdrew its participation from the Joint Tax Program, the implementation of which was continued by the Organization of American States with the technical and financial support of the Inter-American Bank for Development, and from 1970 under the sole sponsorship of the Organization of American States.

The instruments of technical cooperation by means of which the tax program fulfills its aims are research, technical assistance, and training. The training of public officials from tax services has been one of the basic aims of the program from its inception. Accordingly, the establishment of an inter-American center for tax training was proposed during the Fourth Annual Meeting of the Economic and Social Inter-American Council, held in Buenos Aires (Argentina) in 1966.

The above-mentioned proposal was accepted and it was decided that a detailed project would be submitted to the next Annual Meeting. The following year, the establishment of the Inter-American Center for Tax Studies was approved at the Fifth Annual Meeting of the Economic and Social Inter-American Council held in Viña del Mar, Chile, in 1967.

Several countries offered to be host to the headquarters of the new center, and, after consultation with member countries, an agreement was reached to establish the CIET's headquarters in Buenos Aires.

## 2. The purposes of the CIET

Under Article II of the relevant agreement, the purposes of the CIET are the following:

i) to provide training in fiscal policy and tax administration to public officials from member countries of the Organization of American States;

ii) to perform research and analysis on the typical problems of the American countries, considering both fiscal structure and tax administration, with the purpose of preparing material to be used in the teaching activities of the Center;

iii) to divulge the results of research and to maintain for that purpose an information service available to fiscal administration services of the inter-American system.

iv) to give advice to fiscal administration services in order to organize national institutions for the training of officers, or for preparing courses with the same purpose.

Within this framework, CIET has developed an intense activity which includes courses, seminars, symposia, research, and publications.

Moreover, the CIET has maintained permanent contact with other institutions and programs that provide tax training in Latin America. Thus, there has been a close collaboration with the Inter-American School of Public Administration (EIAP) of the Getulio Vargas Foundation, located in Rio de Janeiro, Brazil; with the Central American Institute of Public Administration (ICAP), located in San José, Costa Rica; and with the Institute for the Integration of Latin American (INTAL), located in Buenos Aires.

With the purpose of decentralizing its activities, CIET has appointed Regional Professors: one at ICAP; a second in the Andean Group, Lima, Perú; and a third at EIAP. This decentralization is aimed at collaborating with economic integration processes going on in America (the Latin American Free Trade Association, the Central American Economic Market, and the Andean Group).

CIET costs, such as staff salaries, travel expenses of professors giving courses, and the granting of scholarships, are financed by the Organization of American States and additionally by contributions from the Argentinian Government.

## 3. The CIET's training activities

From its foundation, the CIET has developed an intense activity in the field of tax training. Starting with the first regional course on Tax Policy and Administration held in June 1969, through December 31, 1975, CIET offered 121 courses covering different areas of taxation which were attended by 4,941 students. Among these courses, 29 were multinational (inter-American and regional), attended by 782 students, and 92 were national courses, attended by 4,159 students.

For multinational courses, scholarships covering traveling costs and living expenses are granted.

Courses offered by CIET are varied, according to the countries to whom they are offered or according to the field of taxation which is covered. In the first case, courses are divided into inter-American courses, regional courses, and national courses; in the latter instance, courses are divided into Tax Policy, Tax Law, Tax Technique, and Tax Administration.

## 4. Inter-American courses

Inter-American courses are given at CIET's headquarters in Buenos Aires and are offered to students coming from all member countries.

These courses are the highest level of CIET's courses. They are aimed at providing suitable training for graduate experts up to professionals with university degrees coming from all member countries.

Students are selected from top level officials discharging directive or advisory duties in the tax administration services or in agencies formulating the tax policy, as well as from tax professors from high level teach-

1. This report has been prepared on the basis of CIET's document No. 836, Reseña de las actividades del Centro Interamericano de Estudios Tributarios, 1969-1975, which was kindly provided by CIET's Director, Mr. Hugo A. de Marco.

ing centers, provided these officials and professors have the possibility to influence the improvement of the tax systems and administration services in their countries or the university teaching.

The first inter-American course was given in 1970 for 5 months and was attended by 31 students from 17 countries. This course covered different areas of taxation, namely: Tax Law, Tax Administration, Tax Technique and Tax Policy.

The next courses were shorter (no more than 3 months) and were devoted to analysis in depth of one area of taxation only.

The second course, in 1971, was attended by 29 students from 14 countries and covered Comparative Latin American Tax Law.

The third course was given the same year, 1971, was attended by 30 students from 12 countries and covered Tax Administration.

The fourth course, in 1972, was attended by 32 students from 17 countries and covered Tax Technique.

The fifth course, in 1973, was attended by 35 students from 15 countries and covered Taxation as an Instrument of Economic Policy.

The sixth course, in 1974, was attended by 24 students from 13 countries and also covered Taxation as an Instrument of Economic Policy.

The seventh course, in 1975, was attended by 22 students from 17 countries and covered Tax Law.

### 5. Regional courses

Regional courses and seminars are given at CIET's headquarters in Buenos Aires or in another country agreed upon with the countries requesting the course; they are offered to students coming from a certain group of member countries (mainly subregional groups).

These courses are normally short courses covering tax problems of integration which are of common interest for one region or group of countries. In general, regional courses and seminars have been offered with the purpose of analyzing tax problems arising within the integration movements going on in the continent, as well as different aspects of customs duties having common features in come of the integration areas.

On request of several countries, one of the regional courses was devoted to tax auditing and other subjects connected with tax administration. Nevertheless, the emphasis of regional courses has been given to regional problems of taxation, particularly the regional course offered in Buenos Aires to participants from LAFTA countries, the course with which CIET's activities started in 1969. From that year through 1975, 22 regional courses and seminars have been offered to 579 participants.

### 6. National courses

National courses are organized in Argentina or in other member countries requesting them; they are offered to nationals of a certain member state only. Moreover, under the agreement with the Argentinian Government, every year CIET gives two Argentinian national courses on subjects of interest to that Government.

The national courses are normally short courses. They have been offered with the purpose of improving the capabilities of public officials working at national tax services, as regards specific aspects of the tax disciplines. National courses and seminars have moreover been aimed at giving support to the technical assistance provided by the tax program to a certain country, by means of training national officials on taxation subjects related to the purposes of the technical assistance that is being provided to the same country.

In this way the Center tries to create the technical ability to enable a country to absorb and implement the recommendations made by the tax program, as well as to encourage and to make it easier for a country to train its officials with its own resources.

Programs of national courses include all tax fields related either to external or internal taxation, and cover Tax Policy, Tax Law, Tax Administration, and Tax Technique.

The emphasis on different subjects has changed according to the areas in which the tax program provides technical assistance to the member country. Accordingly, in the first year of CIET, these courses were devoted almost entirely to internal taxation, later encompassing greater emphasis on subjects related to the administration and technique of taxes on foreign trade.

As regards internal taxation, in recent years, more emphasis has been put on specific aspects of tax administration, such as tax control and support systems, covering the registry of taxpayers, tax statistics, and data processing.

Up to 1975, 92 national courses were given, attended by 4,159 participants.

As stated, according to the field of taxation covered, courses are given on Tax Policy, Tax Law, Tax Technique, and Tax Administration. The purpose of this division is that, in different courses, different emphasis is given to a particular area of taxation; nevertheless, all the courses contain a general reference to areas of taxation other than the selected one, in order to provide a better understanding of problems.

### 7. Courses on Tax policy

The main purpose of courses on Tax Policy is to provide capabilities and knowledge regarding the use of taxation as an instrument of economic policy.

A fundamental idea in these courses has been that macro-economic variables are changed and can be guided by taxation. That is to say that every tax has some effect on macro-economic variables, it therefore being possible that a tax, in addition to producing the revenue necessary to the government, can be used as an instrument of economic policy of the same government.

Consequently, in these courses, analysis and discussion with the participants have been encouraged on both theoretical and practical issues arising from the Latin American situation which have to be taken into account in recommending a tax reform or in discussing tax problems emerging from economic integration.

The emphasis of courses on Tax Policy has been put on decisions which have to be taken by the tax authoritiess of central governments, paying therefore special attention to taxation problems related to foreign trade and to other key variables of development such as private consumption, private investment, production factors, income distribution, etc.

Special consideration has been given to the fact that students attending these courses have varying professional backgrounds and come from different governmental agencies. Accordingly, as long as the duration of the course had made it possible, the first part has been devoted to providing a general knowledge of economics, public finance, and fiscal policy, while the second part has been devoted to analyzing the relationship between the purposes of the economic policy and the tax instruments. Moreover, in seminars, the possibility of applying theoretical views to the economic reality of the Latin American countries has been analyzed.

Courses on Tax Policy covering the tax systems as a whole have had an average duration of 12 weeks, while those referring to integration problems and tax harmonization have lasted from 4 to 6 weeks.

From CIET's foundation in 1969 through 1975, 26 courses on Tax Policy have been given, 7 of which dealt with tax harmonization.

### 8. Courses on Tax Law

In courses on Tax Law, the fundamental principles and institutions of tax law are studied covering general tax law, as well as the law regarding tax crimes and penalties, tax administration, and tax procedures, either in their theoretical approach or in the positive legislation with special consideration to the Latin American situation.

In this way, CIET tries to improve professional capabilities and training in tax law for officials working in tax administration services.

On the other hand, by analyzing the comparative Latin American Tax Law, it is assumed that the harmonization of general rules is prompted, facilitating the integration of the American countries.

The process of tax codification has been stimulated by these courses, which not only have stirred interest in codification, but have resulted in the preparation of tax codes or in the gathering of the material necessary to this purpose, or in the appointment of drafting commissions having ex-participants in the courses as some of their members.

From CIET's foundation in 1969 through 1975, 12 courses on Tax Law have been given, 3 of them multinational.

### 9. Courses on Tax Technique

Courses on Tax Technique have been given in order to complement the technical assistance provided by the tax program with rapid training, at the national level, of a good number of officials specialized in different areas of taxation.

The training on tax technique is aimed at the double purpose of showing national officials, first of all, series of technical alternatives regarding the different types of taxes that can be levied, contributing in this way to arriving at the best decision for the country, and, once this decision has been taken, to training local experts on technical aspects of those types of taxes that have been chosen.

Consequently it is considered that courses on Tax Technique are needed when the first steps for tax reform are being taken as well as after the reform has been adopted.

During the first years of CIET's activities, courses on Tax Technique regarding internal taxation have analyzed, with greater frequency, different alternatives available for taxation on goods and services — i.e. the technique of the value added tax, the technique of the suspension of tax and other technical alternatives — as well as those available for taxation on income of individuals and companies and for other types of taxes.

This has enabled tax administration services to have a more complete knowledge of the possible technical alternatives and then, when the opportunity to carry out a tax reform has arrived, to have more accurate instruments to assess the effects of each of the measures to be taken.

In the same way, courses on Tax Technique have followed changes already adopted, as a consequence of which it has been necessary to train national officials in order to obtain more effectiveness in the implementation of a tax reform.

From 1969 through 1975, 52 courses on Tax Technique were given, 13 related to internal taxation and 39 dealing with foreign trade.

### 10. Courses on Tax Administration

The basic orientation of courses on Tax Administration has been, in general, very similar to that of courses on Tax Technique, due to the fact the fields covered by both are directly connected with the technical assistance of the tax program.

The program of courses on Tax Administration has included the analysis of general principles of tax administration within the framework of Latin America, with special emphasis on the main substantive functions, such as tax collection and control, and also on support systems, covering within this plan the registry of taxpayers, tax statistics, and data processing.

These courses have evolved from the isolated analysis of some problems of tax administration, such as those related to tax control, towards an integration of the different functions performed by the tax administration and the development of a model support system containing the necessary interdependence btween the different areas of the tax administration.

As in the case of courses on tax technique, courses on tax administration have been an answer to the need to implement, at an administrative level, those reforms that a tax system has suffered at its legal level; for this purpose it has been necessary to train local officials in the use of new taxation techniques.

There have been 31 courses on different aspects of tax administration.

### 11. Training activities for the year 1978

What has been said up to now summarizes the CIET's background, purposes and activities, especially its training activities with the different kinds of courses included in these activities. For 1978, the program of CIET's activities includes the following multinational (inter-American and regional) courses:

i) an inter-American course on Tax Administration to be held for three months at CIET's headquarters in Buenos Aires;

ii) a regional course on Income Taxation for Central America, Panama and the Dominican Republic to be held for one month in San José, Costa Rica;

iii) a regional course on Taxation on Goods and Services for LAFTA member countries to be held for one month in Brasilia.

For all these courses, scholarships are offered to the selected candidates.

According to what has been said above, in order to qualify to attend these courses, it is necessary to have a profession related to the course's subject and to be a public official or university professor discharging duties also connected with the course's subject.

Candidates apply through official channels and must be sponsored by Governments of member countries.

IFA INTERNATIONAL FISCAL ASSOCIATION NEWS

# Journée d'étude 19 mai 1978: groupements français et belgo-luxembourgeois

## Les conventions franco-luxembourgeoise et franco-belge en vue d'éviter les doubles impositions répondent-elles aux nécessités actuelles?

# Première partie

**Observations de la section luxembourgeoise du groupement belgo-luxembourgeois de l'association internationale de droit fiscal concernant certains points de la convention franco-luxembourgeoise ***

### 1. Statut fiscal des intérêts payés de la France vers le Luxembourg

D'après l'article 9 de la convention du 1er avril 1958 telle que modifiée par l'avenant du 8 septembre 1970 l'état de provenance des intérêts garde le droit de prélever un impôt de retenue à la source de 10 pour cent en règle générale (par exception 12 pour cent sur les obligations négociables émises avant le 1er janvier 1965).

Cette disposition n'a qu'une incidence très limitée au Luxembourg, alors que le Luxembourg ne connait une retenue d'impôt sur intérêt que pour les obligations où elle est d'ailleurs réduite à 5 pour cent. Cette retenue d'impôt est d'ailleurs appelée à disparaître selon un projet de loi (No. 2160).

Cette retenue d'impôt qui n'existait pas dans la convention originaire de 1958 a seulement été introduite par l'avenant de 1970.

Cette convention est d'ailleurs la seule signée par le Luxembourg à permettre le maintien d'une retenue d'impôt sur les intérêts, toute les autres conventions prévoyant la suppression pure et simple de toute retenue d'impôt sur intérêts.**

Les inconvénients d'une telle retenue d'impôt et la double imposition partielle qui peut se produire ont été soulignés à juste titre dans le rapport du comité des affaires fiscales de l'O.C.D.E. 1977 dans ses commentaires (No. 13 et ss. ad. Art. 11).

D'après les termes de la convention le bénéficiaire luxembourgeois des intérêts jouit d'un crédit d'impôt pour l'impôt français retenu à la source, mais limité à l'impôt luxembourgeois dont le bénéficiaire est redevable au Luxembourg du chef des mêmes revenus.

A cet effet l'impôt luxembourgeois qui constitue la limite d'imputation est calculé sur le bénéfice net d'opérations financières c'est-à-dire en prenant en considération non seulement le coût du refinancement, mais encore les frais administratifs en rapport avec chaque opération considérée individuellement.

Par conséquent, la retenue en France étant de 10 pour cent et l'impôt sur les collectivités à Luxembourg étant de 40 pour cent, il faudrait que le bénéfice net soit de 25 pour cent sur les intérêts perçus afin que le bénéficiaire luxembourgeois des intérêts puisse intégralement absorber le crédit d'impôt à la raison de la retenue d'impôt française.

Cet exemple chiffré montre de façon éclatante que le créancier luxembourgeois, surtout un établissement financier, ne réussira jamais à éviter, malgré la convention, une double imposition partielle car d'un part l'impôt retenue dans l'état de provenance est calculé sur le montant brut des intérêts tandis que les mêmes intérêts ne se retrouvent dans les résultats du bénéficiaire que pour leurs montants nets.

La loi interne luxembourgeoise permet dans son article 13 (loi du 4 décembre 1967) à déduire à titre de dépense, les impôts personnels étrangers prélevés à charge d'un résident luxembourgeois. Cette loi ne contient pas de condition particulière aux termes de laquelle ce régime ne serait d'application que dans le cas d'inexistence de convention de double imposition. En conséquence des bailleurs de fonds qui avaient sous l'empire de la convention de 1958 conclu des contrats de prêt avec des débiteurs français et qui ont été surpris par la modification résultant de l'avenant de 1970 ont essayé de réduire l'impact de cette double imposition partielle créée par l'avenant de 1970 en faisant valoir la déduction de la fraction de la retenue d'impôt française dans la mesure où elle n'a pas pu être utilisée à titre de crédit d'impôt. L'Administration des Contributions luxembourgeoise

* Par André Elvinger et Jean Hoss.

** Si l'on excepte l'application limitée d'une retenue d'impôt sur intérêts permise par les dispositions de l'article 11 de la convention belgo-luxembourgeoise du 17 septembre 1970.

toutefois par une circulaire (2 avril 1974) a fait connaître son interprétation aux termes de laquelle une convention de double imposition règlerait de façon exhaustive le système d'imposition des revenus ayant leur source dans l'état contractant et que partant les contribuables luxembourgeois ne seraient plus autorisés à invoquer les dispositions de droit interne destinées à limiter l'incidence des doubles impositions. Bien que cette interprétation soit intervenue à l'occasion de la convention belgo-luxembourgeoise, elle a été appliquée mutatis mutandis à la convention franco-luxembourgeoise.

Le Gouvernement luxembourgeois vient de déposer un projet de loi destiné à modifier fondamentalement les dispositions de droit interne luxembourgeois d'atténuation des double impositions. Ce projet de loi qui s'inspire des dispositions allemandes a appelé de la part de l'Association des Banques et Banquiers les plus vives réserves (avis de l'Association des Banques et Banquiers du 23 mars 1978).

Ce projet de loi entend introduire la règle de l'imputation de l'impôt étranger lorsqu'il n'y a pas de convention de double imposition. Toutefois on maintient la limite du crédit d'impôt à l'impôt luxembourgeois qui sera évidemment déterminé par rapport à un revenu imposable net. De plus le projet de loi prévoit que l'imputation doit s'opérer pays par pays. Le projet de loi prévoit encore et ceci a son importance dans le cadre des conventions de double imposition, que tout déchet d'impôt étranger qui ne peut pas être utilisé dans le cadre de la convention de double imposition ne peut pas être déduit à titre de dépense. Le Gouvernement entend donc par voie législative consacrer la circulaire du 2 avril 1974.

On constate surtout que du coté français, on a pris des mesures pour atténuer l'incidence de l'impôt prélevé à l'étranger et pour permettre notamment de plus grandes facilités d'utiliser l'impôt étranger à titre de crédit d'impôt en France. Ainsi, selon nos informations, l'administration française (circulaire du 1er avril 1974) autorise les banques, pour déterminer la limite d'imputation, à calculer l'impôt français à partir de la balance globale des intérêts débiteurs et créditeurs afférents à un même secteur d'activité. Par un même secteur d'activité on entendrait selon nos sources, toutes les opérations de l'espèce réalisées — quelle que soit la monnaie utilisée — avec les emprunteurs étrangers.

En conclusion une modification de l'article incriminé de la convention s'impose pour ne pas constituer une entrave insurmontable aux transactions financières entre la France et le Luxembourg. Une telle modification devrait s'inspirer du paragraphe 3 de la convention modèle O.C.D.E. 1977.

### 2. Statut fiscal des établissements français de sociétés luxembourgeoises

L'article 7 de la convention permet le maintien d'une retenue d'impôt mais limitée à 5 pour cent sur les bénéfices d'un établissement stable en France d'une société luxembourgeoise. Cette disposition qui maintient effectivement une double imposition se trouve réglée dans la convention franco-luxembourgeoise à l'instar des conventions Etat-Unis-France et franco-suisse.

Selon les informations obtenues le problème serait résolu de façon plus satisfaisante dans les conventions que la France a conclues avec l'Allemagne et avec la Hollande.

Il s'agit donc ici d'une situation désavantageuse par rapport à deux autres pays du marché commun auxquels la France accorde un traitement plus favorable. Ceci d'autant plus que le Luxembourg ne connait pas de taux différencié pour l'imposition du revenu de l'établissement stable à Luxembourg d'une société étrangère et l'imposition des sociétés luxembourgeoises.

### 3. Insuffisance du champ d'application de la procédure amiable

Actuellement la procédure amiable ne peut être mise en mouvement que dans le cas où la double imposition se réalise au détriment d'un seule et même contributable partant il n'y a actuellement aucun remède dans le cadre des entreprises associées pour ramener les positions divergentes de deux administrations fiscales nationales sur un dénominateur commun.

A ce sujet on ne peut que recommander l'intégration du deuxième paragraphe de l'article 9 de la convention modèle 1977 et les commentaires de la convention modèle sont suffisamment éloquent. Comme ni le Luxembourg ni la France n'ont exprimé des réserves, l'insertion d'une telle ajoute ne devrait pas poser de problème.

### 4. Statut fiscal d'un établissement stable luxembourgeois d'une société étrangère et non française dans les rapports de cet établissement avec la France

La convention ne s'applique pas aux relations qu'un établissement stable luxembourgeois d'une société non française peut développer avec la France.

Ceci pose l'épineux problème d'une éventuelle application de la convention que la France pourrait avoir conclu avec le pays dont la société entretenant l'établissement stable à Luxembourg dépend.

Selon nos informations la convention franco-belge comporterait en faveur notamment des banques des établissements financiers et de crédits non-résidents (établissements stables) une clause particulière les assimilant pour l'application de ladite convention à des résidents.

L'insertion d'une telle clause d'assimilation dans la convention franco-luxembourgeoise serait certainement à saluer.

Le projet de loi No. 2160 prévoit la possibilité d'étendre aux établissements stables luxembourgeois de sociétés étrangères les dispositions internes luxembourgeoises destinées à éviter les doubles impositions. Toutefois actuellement les établissements stables ne bénéficient d'ailleurs d'aucune convention que le Luxembourg a conclu et les établissements stables partant se trouvent dans une situation désavantagée.

D'ailleurs dans son avis précité du 23 mars 1978 sur le projet de loi No. 2160 l'Association des Banques et Banquiers a réclamé l'assimilation par voie légale des établissements stables aux sociétés luxembourgeoises pour l'application dudit projet de loi.

### 5. Statut fiscal des établissements luxembourgeois de sociétés françaises

L'inapplication de la convention à un établissement luxembourgeois d'une société française est particulièrement choquante lorsque cet établissement luxembourgeois touche notamment des dividendes, intérêts ou redevances de France. D'une part l'établissement ne bénéficie pas des éventuels allégements des retenues d'impôt, mais encore ne bénéficie pas à Luxembourg des dispositions de droit interne destinées à atténuer l'effet des doubles impositions.

### 6. Problème posé par l'interprétation divergente du terme dividende

Une société de personnes qui distribue ses bénéfices aux associés n'est pas censée avoir distribué d'après le droit luxembourgeois des dividendes. Donc les bénéfices payés à un associé étranger d'une société de personnes luxembourgeoise ne sont pas soumis à une retenue d'impôt. Partant un commenditaire français touchant des bénéfices d'une société de personnes luxembourgeoise ne subi pas de retenue d'impôt à la source.

Toutefois cette distribution de bénéfices est considérée en France comme un dividende, mais comme la société distributrice n'est pas une société de capitaux, le bénéfice qualifié de dividende, ne peut pas bénéficier en France du régime fiscal société-mère—société-fille, mais est imposé intégralement en France ceci par application des articles 145 et 216 du Code générale des impôts français.

La seule façon d'éviter la double imposition serait de considérer ces bénéfices comme des bénéfices commerciaux des associés ou alors d'étendre le privilège société-mère—société fille à tous les cas où les revenus sont considérés comme étant des dividendes.

### 7. Non-application du privilège société-mère—société-fille à l'impôt sur la fortune

La convention ne prévoit pas l'extension dudit privilège à l'impôt sur la fortune.

Evidemment les négociateurs luxembourgeois pourront soutenir qu'il n'y a pas lieu d'éviter une double imposition puisque la France ne connait pas d'impôt sur la fortune.

Toutefois cet argument n'est pas pertinent alors que la Belgique ne connait pas non plus d'impôt sur la fortune, mais que la convention belgo-luxembourgeoise étend ledit privilège également à l'impôt sur la fortune. De plus les arguments économiques militeraient en faveur d'une telle extension également dans la convention franco-luxembourgeoise. En effet il faut toujours prendre en considération l'imposition globale d'un pays donné quelqu'en soit les composantes. Ainsi on peut notamment relever que la charge fiscale sur le revenue des collectivités est plus élevée en France (50 pour cent) contre 46 pour cent seulement au Luxembourg. De plus tous les impôts, notamment l'impôt sur la fortune pour ne pas être confiscatoires, doivent être payés ay moyen des revenus et la charge de l'impôt sur la fortune à Luxembourg est encore plus sensible du fait que cet impôt ne constitue pas un impôt déductible pour la détermination du bénéfice imposable au titre d'impôt sur le revenu.

### 8. Problème de l'attribution des bénéfices en cas de chantier de construction

Bien que ce problème ne soit pas spécifique et particulier à la convention franco-luxembourgeoise, mais se retrouve dans toutes les conventions, son importance mérite aux yeux des rapporteurs d'être relevée.

Pour les chantiers, surtout pour les chantiers importants, d'importants travaux préparatoires sont nécessaires au siège de l'entreprise pour préparer les plans, établir les spécifications des produits à utiliser, élaborer les cahiers des charges, tester les produits offerts, passer les commandes, surveiller la fabrication des produits commandés auprès de tiers ou fabriqués à l'intérieur de l'entreprise au siège. Les produits finis sont alors acheminés au chantier où peut s'effectuer, le cas échéant, un très simple travail de montage. Le bénéfice réalisé par l'entreprise à l'occasion d'un chantier déterminé se compose du bénéfice réalisé sur les opérations de montage d'une part et d'autre part sur les bénéfices réalisés sur les fournitures. La délimitation de ces bénéfices est extrêmement malaisée et peut surtout donner lieu à des appréciations divergentes des autorités fiscales des deux pays impliqués avec comme conséquence des contentieux fiscaux suivis le cas échéant d'une procédure de concertation amiable.

Le seul remède efficace consisterait dans une procédure de concertation amiable préalable. Les termes actuels de la procédure amiable ne prévoient pas une concertation préalable qui pourrait être déclenchée par le contribuable redoutant une double imposition, mais le contribuable en est réduit à subir alors des doubles impositions quitte à recourir aux possibilités de recours contentieux offerts dans les deux pays avec tous les inconvénients et incertitudes que comporte une telle situation.

# Summary

## of the paper prepared by Messrs. André Elvinger and Jean Hoss for the Luxembourg delegation *

*A common study meeting of the France and Belgium/Luxembourg I.F.A. groups recently dealt with the following subject:*

*"Do the France-Luxembourg and France-Belgium tax conventions meet current needs as regards the avoidance of double taxation"?*

*The observations of the Luxembourg section of the Belgium/Luxembourg I.F.A. group are outlined below on certain points of the France-Luxembourg Tax Convention.*

### 1. The fiscal status of interest paid from France to Luxembourg

*According to Article 9 of the France-Luxembourg Tax Convention of April 1, 1958, as amended by the Protocol of September 8, 1970, the source country retains the right to levy a withholding tax on interest payments at source which may not exceed 10 percent (an exception applies to certain negotiable obligations issued before January 1, 1965; on such payments France may levy a withholding tax of 12 percent). The tax withheld in France may be credited against Luxembourg taxes.*

*This provision has little practical impact for Luxembourg since the imposition of such a withholding tax is not known there. An exception to this rule exists with respect to interest on bonds, where the withholding tax is restricted to a rate of 5 percent. However, the abrogation of this tax is currently being considered in a bill (No. 2160).*

*In the original France-Luxembourg Tax Convention of 1958, no such withholding tax was provided for, and the current tax convention is the only one signed by Luxembourg where the imposition of such a withholding tax is permitted (with a rather unimportant exception in the Belgium-Luxembourg treaty).*

*The drawbacks of such a withholding tax and the possible partial double taxation which may result were highlighted in the commentary to Article 11 of the OECD Model Convention. The following example may explain the problem:*

> *The French withholding tax amounts to 10 percent (on the gross amount of interest). The Corporate Income Tax in Luxembourg amounts to 40 percent. Consequently, in order to be in a position to claim a full tax credit for the French withholding tax, the net profit on such revenue must amount to at least 25 percent.*

*Currently, possible partial double taxation cannot be avoided by virtue of the Tax Convention between France and Luxembourg. Since the unilateral measures of relief in Luxembourg (Article 13 of the Law of December 4, 1967) (i.e. deduction of foreign taxes from the taxable base) are only granted in the absence of a convention, a Luxembourg creditor may not always succeed in avoiding this partial double taxation.*

*Those creditors that concluded contracts with French debtors under the authority of the Convention of 1958 and were surprised by the 1970 amendment introducing the withholding tax have tried to reduce the double tax burden by deducting French taxes from connected income insofar as such French taxes could not be credited against Luxembourg taxes. However, the Luxembourg tax authorities rejected this procedure (Circulaire of April 2, 1974), arguing that tax treaty provisions completely replace unilateral relief measures.*

*The government of Luxembourg has drafted a bill which is devoted to fundamentally amending the provisions dealing with unilateral tax relief. The bill is similar to legislation in the Federal Republic of Germany, but substantial objections have been made by the Banker's Association.*

*This bill proposes the introduction of a tax credit in the absence of a tax convention. There will be a country per country restriction. Moreover — and this is the significant feature of the bill in the context of tax conventions — that part of foreign tax that exceeds the amount which can be credited under a tax treaty may not be deducted as an expense. The Government consequently wants to convert the position of the Circulaire of April 2, 1974 into law.*

*On the French side it is often stated that they have introduced measures which are directed at mitigating the impact of foreign withholding taxes and especially at easily granting a tax credit for foreign taxes in France. Thus, the French authorities authorized (Circulaire of April 1, 1974) banks to derive the French tax and, respectively, the amount of foreign taxes to be credited, from the gross balance of interest in taking into account the share of foreign borrowers within the specific types of activities undertaken.*

#### Conclusion

*An amendment of the criticized article of the France-Luxembourg Tax Convention should be made in order to avoid the appearance of insurmountable difficulties with respect to financial transactions. Any amendment should follow the format of Paragraph 3 of the OECD Model Convention of 1977.*

### 2. The fiscal status of French permanent establishments owned by Luxembourg companies

*Article 7 of the France-Luxembourg Convention permits the imposition of a withholding tax of 5 percent on the profits of a permanent establishment in France owned by a Luxembourg company (in addition to the Corporate Income Tax). This in fact represents double taxation of the kind that is found in the U.S.A.-France and Switzerland-France Treaties. On the other hand, this problem seems to be solved more satisfactorily in the France-Netherlands and France-West Germany Conventions.*

*Consequently this represents a disadvantagous situation in comparison with two other EEC-countries which are granted more favourable treatment by France. This is especially unsatisfactory since Luxembourg does not differentiate in the area of tax rates between permanent establishments owned by resident or non-resident companies.*

### 3. Insufficiencies in the mutual agreement procedure

*For the time being, the Convention's mutual agreement procedure cannot be demanded if double imposition of taxes is levied to the disadvantage of one and the same taxpayer. There is currently no remedy for affiliated companies which seek the reconciliation of deviating positions of two national tax authorities (both taxing part of the same profits).*

*In this context one can only recommend the insertion of Article 9, Paragraph 2 ("Associated enterprises") of the OECD Model*

* This summary was made by the Editors of the BULLETIN who are solely responsible for its contents.

Convention 1977 into the existing treaty. Since neither France nor Luxembourg has announced any objection, this amendment should not present any problem.

## 4. The fiscal status of a Luxembourg permanent establishment owned by a foreign (non-French) corporation with respect to connections of that permanent establishment with France

*The Convention does not cover those situations where a Luxembourg permanent establishment owned by a non-French company deals with France. Here, the difficult problem arises as to whether a convention concluded between France and the third country in question could be applied.*

*The insertion of a clause, such as that of the France-Belgium convention, whereby permanent establishments of foreign banks in Belgium are considered to be residents of Belgium for tax purposes, would certainly be welcomed.*

*Bill No. 2160 provides for the possibility of extending the application of unilateral measures for the avoidance of double taxation to Luxembourg permanent establishments of foreign companies. Currently, such permanent establishments cannot benefit from any treaty and therefore find themselves in a disadvantageous position.*

## 5. The fiscal status of a Luxembourg permanent establishment owned by a French corporation

*The inapplicability of the France-Luxembourg Tax Convention to a Luxembourg permanent establishment owned by a French company produces particularly severe results if this Luxembourg permanent establishment receives dividends, interest or royalties from France. On the one hand, the permanent establishment does not benefit from any possible relief with respect to taxes withheld by France, and on the other hand, it cannot claim the unilateral measures of relief either.*

## 6. Problems due to the definition of the term "dividend"

*Profit distributions of a "société de personnes", e.g. distributions from a partnership to its associates or partners, are not deemed to be dividend payments under Luxembourg law. Consequently, no withholding tax is levied if a Luxembourg partnership distributes profits to non-resident partners, e.g. if a French silent partner (commanditaire) receives such payments. These profit distributions to silent partners or to associates are considered dividends in France, but since the distributing company is not a corporation the affiliation privilege cannot be claimed.*

*The only possibility for avoiding double taxation would then be either to consider the profits as commercial profits for the partner or to extend the affiliation privilege to all those cases where such income is deemed to represent dividends.*

## 7. Non-application of the parent-subsidiary company privilege with respect to the net worth tax

*The Convention does not provide for the application of the above-mentioned privilege to the net worth tax. One could argue that no double taxation takes place since France does not levy a net worth tax. However, Belgium does not levy such a tax but the Belgium-Luxembourg Tax Convention contains this privilege nonetheless. There are also economic reasons which call for the introduction of this provision into the France-Luxembourg Convention.*

## 8. Problems as regards profit allocation in the case of a building site

*Although these problems are not found exclusively in the France-Luxembourg Convention but occur in all such conventions, they deserve some attention in the eyes of the reporters. As regards building sites, in particular important ones, the major part of preparation work necessarily takes place at the seat of the enterprise. When the items are finally transported to the building site, the actual assembly work is often rather simple. Therefore, the profit derived by the enterprise through a certain building site consists of the profit from the actual assembly work on the one side and the profit resulting from the delivery of the components on the other. The delineation of those parts of the profit is often very difficult and may result in differing valuation by both tax authorities involved, thus leading to the necessity of having a mutual agreement procedure.*

*The only efficient remedy to this problem would be to institute a mutual agreement procedure at an earlier stage. This possibility is, however, not open to taxpayers at present and consequently the uncertainties involved must always be accepted.*

# TAX GLOSSARY

by H.W.T. PEPPER *

**FORTUNE, IMPOT SUR LA** — (France) Net wealth tax.

**F.O.T.** — Free on Truck (lorry) for road transport. (See also F.O.B. and F.O.R.)

**FOOTAGE TAX** — A tax levied in a few countries on films imported for public exhibition and usually computed as a specific levy of so much per foot of film. The tax is administratively relatively simple to compute and collect but much more arbitrary in its instance than one based on the "value" of the film expressed as the cost of hiring or renting it. (See FILM HIRE TAX.) It may be noted that where foreign films are imported for exhibition they are normally re-exported after a limited period of time, during which they are available for exhibition for a hire or rental charge which is usually based on a percentage of the takings from admission charges, so that an ordinary customs duty type of levy is not really inappropriate.

**FOOTBALL POOLS TAXATION** — A tax on the amounts staked on forecasting the results of association football matches. In Britain the levy is known as the Pools Betting Duty and is charged at 33 1/3 percent.

**FOREIGN EXCHANGE ENTITLEMENT CERTIFICATE** — A levy currently imposed in Sri Lanka on the remittance of money outside the country which applies, inter alia, to the dividends of foreign companies operating in Sri Lanka. The rate of levy, i.e., the price of the certificate, has varied from 25 percent to 50 percent of the sum to be remitted.

**FOREIGN EXCHANGE TAX** — In effect, a tax on money spent in other countries by one's own residents, e.g., on tourism, i.e., in a sense on "luxury" spending which also has an adverse effect on the balance of payments. Such levies have been made in the U.S.A. and Israel, though restrictions on the amount of foreign currency which may be bought by a resident are more common. As to restriction of overseas investment, see INVESTMENT PREMIUM.

**FOREIGN INTERNATIONAL SALES CORPORATION (F.I.S.C.)** — See DOMESTIC INTERNATIONAL SALES CORPORATION (D.I.S.C.).

**FOREIGN TAX CREDIT** — In the U.S. tax system, citizens, residents and domestic corporations are taxable on world income, i.e., all income from sources within and outside the U.S. To eliminate double taxation a direct credit against the U.S. tax is allowed for foreign income tax incurred. The credit is limited to that proportion of the U.S. tax which the income from sources outside the U.S. bears to the total income — any foreign tax in excess thereof can be carried back 2 years and then forward, but a similar limitation applies in every year.

**FOREIGN TAX RELIEF** — Relief from local tax on income from abroad which has already suffered foreign tax. (See DOUBLE TAXATION and UNILATERAL RELIEF.)

**FOREIGN TRAVEL TAX** — A tax on the price of tickets for air and other travel to other countries by one's own residents, as a levy on luxury spending and as a means of easing pressure on the balance of payments (to the extent that people are discouraged from going abroad at all). The tax is not the easiest to administer — it is necessary to exclude visiting tourists, and to provide against avoidance by one's own nationals buying tickets from a point just outside one's frontiers after a short trip abroad from within the country. The most notable instance of the application of such a tax is that introduced in Israel.

**FORESTRY** — Because of factors such as the long time it takes for a tree to mature into usable timber, and the need to encourage forestry to prevent soil erosion and provide water catchment areas, tax regimes are often biased in favour of forestry. For example, Japan permits separate taxation of forestry income with a 33 percent standard deduction; Britain and Sweden abate the incidence of death duties.

**FORFAIT** — "Forfait" is the system used in France as a simple way of computing the sales tax (V.A.T.) due from small traders (about 75 percent of the whole) without calling for monthly tax declarations. Tax for a year is computed on the basis of the trading and profit and loss accounts for the previous calendar year and the liability so computed is payable in equal instalments over the taxable period. Recalculations are made only at two-yearly intervals unless the trader or the tax administration has reason to seek an earlier revision.

**FORFAITAIRE** — The forfaitaire system (also known as Phasenpauschalierung in Austria, and Una Tantum in Italy) is that sometimes adopted under cascade sales tax systems whereby certain products are removed from the multi-stage application of the tax. Instead the selected products are subjected to what amounts to a manufacturer's tax, charged at a rate applicable at a single stage, which will produce a tax yield equivalent to the total of the amounts of tax which would have been charged at various stages under the cascade system. A system of this type may sometimes be used in conjunction with a governmental policy of price-control of certain commodities so as to quantify precisely the tax applicable, a necessary factor in determining the fair price.

**FORMATION TAX** — This term is applied to tax levied on the formation of a company in certain countries, the tax usually being proportional to the nominal or issued capital, or to both. This type of tax is little different from the stamp or registration duties fairly widely levied in countries which impose such charges either under stamp or registration laws or in the company law itself. The justification for such taxation is either (a) as a form of registration duty or fee levied to cover the administrative cost of supervising corporate formations and activities for the protection of the public, or (b) as a charge made for the privilege of limited liability and the right to raise

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

capital from the public often at more favourable rates of dividend and interest than that on loans which could be obtained from the money market.

**FORMS, TAX** — It is usual to design special forms upon which taxpayers may declare their taxable income, sales, etc. for tax purposes. The form will be so designed as to facilitate the task of the Tax Department in assessing and collecting the tax, and at the same time will usually draw the taxpayer's attention to reliefs he may claim, etc., as well as to his statutory duty to make accurate declarations and to the penalties that may fall upon him if his declaration is incomplete or false.

**FORMUESKAT** — (Denmark) Capital (wealth) tax.

**FRACTIONAL PAYMENTS** — The method by which sales tax is collected under the value-added system, i.e., tax being paid each time goods are sold, on the value added by the trader selling the goods, each payment being a "fraction" of the total tax ultimately due.

**FRAIS et CHARGES** — (France) Expenses.

**FRANCHISE** — In commercial terms a franchise agreement confers the right to market, or produce under licence, certain goods and services, in a certain area, normally on an exclusive basis, the goods or services being protected by patent or copyright. The right is some times conferred in return for an initial payment to and usually under obligation to purchase supplies and receive technical and promotional services, from the grantor of the franchise.

**FRANK** — To "frank" goods or services means to free them from charge (to tax or other fees), not usually in the sense of granting exemption, but on the basis that the charge has been prepaid or will be paid in a global calculation of tax due instead of a number of small transactions.

**FRANKED INVESTMENT INCOME** — The term used to describe income received by one company from another under a corporation tax regime. The income received by company A from its share holding B is exempted or "franked" from tax in the hands of company A because:

(a) the income has already been charged to corporation tax (upon company B) before distribution by company B to company A; and

(b) redistributions of the income when made later by company A would be subjected to dividend tax on the recipient shareholders.

**FRANKED PAYMENT** — A term used in connection with the revised corporation tax system in Britain. The term refers to the sum of the QUALIFYING DISTRIBUTIONS (q.v.) and the relevant ADVANCE CORPORATION TAX (q.v.) payable by reference to such distributions.

**FRAUD** — In taxation the term is used regarding deliberate EVASION (q.v.) of tax by understatement or omission of income or capital gains or capital, as distinct from innocent omission or error, and from AVOIDANCE (q.v.).

**"FREE BREAKFAST TABLE"** — The "free breakfast table" was a concept of policy, publicised in the 1920's in Britain, which merely implied that imported food, including such items as bacon, butter, eggs, tea and sugar, commonly found on the nation's breakfast table, were free of import duty. At the time, however, government policy was in any event to free most forms of food from customs duties.

**FREE DEPRECIATION** — See DEPRECIATION, FREE.

**FREE PORT** — A port without customs duties, or where such duties are restricted to a few items, traditionally motor fuels, alcohol and tobacco. Among others, Hong Kong, Singapore and Penang are usually regarded as free ports but "free port" facilities are usually provided by most big ports. Such ports, even in developed and highly taxed countries, commonly provide facilities for entrepot trade to be undertaken without payment of duty where the goods are to be re-exported in similar or processed (see EXPORT PROCESSING ZONE) form, or where goods may be held in store, either under bond or not, prior to being brought in within the country's customs area. The latter facility of duty-free storage enables importers to conserve their working capital instead of having large sums tied up in duty paid in advance of the consumption of the goods in question.

**FREE TRADE** — Free trade means trade in goods which are not subject to import duties, a system which was practised in Britain (apart from countervailing duties) from 1867 to 1915. In conditions of perfect competition, completely free world-wide trade would allegedly produce the most optimum conditions for economic development and growth and free trade was an ideal of some economists particularly during the Victorian era in Britain. Since World War II there have been various attempts to reduce the general level of tariffs in the world (e.g., the DILLON and the KENNEDY ROUNDS (q.v.)), for the economic benefit of countries in general, and sometimes specially for the genefit of developing countries on a "trade not aid" basis. (See also FREE TRADE AREA.)

**FREE TRADE AREA** — This term is broadly coincident with the concepts of a "customs union" or a "common market", the fundamental requirement being freedom to trade between the countries which come together in an agreement for a free trade area, customs union or common market but who, generally, present a common tariff of customs duties to the outside world. A possible future development is that by the enlargement of existing free trade areas or the successive linking up of two or more such areas to form a single large area, something akin to the old ideal of world free trade may ultimately materialise.

**FREIGHT CHARGES** — Freight charges are commonly an element in value for customs duty and sales tax purposes and so, in fact, are subjected to such levies when they form part of the price of goods which are themselves subject to such duty or tax. In addition, freight charges may be the separate subject of taxation under V.A.T. and other sales taxes which include transport services within their scope.

**FRIENDLY SOCIETY** — "Friendly Societies" in Britain and in some other countries, particularly in the British Commonwealth, generally orginated in the form of Burial Societies. Individuals, normally in the lower income groups, who joined such societies made small weekly or monthly contributions in order to provide the benefit, in the event of death, of a sum of money hopefully sufficient to cover burial and incidental expenses. The amount paid out on deaths, however, was often based on the amount of monies available in the year when a death took place, calculated as the total funds collected, less a small amount for reserves, divided by the number of persons who died in the accounting period. The scope of such societies has in some instances extended to providing sickness and other benefits. Since friendly societies are usually operated on the mutual principle there is usually nothing identifiable as a profit which could be taxed and where there is an accumulation of invested funds producing interest, exemption from tax on that income is often afforded by the tax laws.

**FRINGE BENEFITS** — Benefits attached to an employment, supplementing the salary, wage, or basic remuneration. Some fringe benefits (which may be in cash or kind) are traditional to certain employments (e.g., free coal to miners in Britain, low interest loans to bank officials), some are designed as a form of tax avoidance. Tax legislation tends more and more to bring fringe benefits into charge to tax, especially those granted to directors or higher-paid (in Britain over £5,000 p.a.) employees. Examples of traditionally taxable benefits include holiday pay, overtime, tips from employers to their customers, while in more recent years the net has been spread to include (in U.K.) share options, loans at sub-economic interest, and free or subsidised use of assets belonging to the employer.

Business entertainment expenses reimbursed by the employer are not normally regarded as fringe benefits of the employee, but, broadly speaking, a deduction in computing the employer's profits is due only if the person entertained is an overseas customer. In the U.S.A. it is currently proposed that a "3 Martini Lunch" should not be deductible but that a more modest expenditure limit should apply to business entertaining. (See also BENEFITS IN KIND.)

**FRUIT AND TREE CONCEPT** — In the area of income tax where it may be difficult to decide whether transactions, particularly the sale of assets, produce income or merely a surplus on realisation of capital, attempts are sometimes made to distinguish between the "fruit" and the "tree". For example, the sale of an income-bearing asset (comparable with a tree which annually bears fruit) such as real estate which has been let to tenants, or a holding of stock which has been producing interest to the holder, would not ordinarily be deemed to produce a profit on the sale (should the sale price exceed cost) although, of course, capital gains tax might apply. Where, however, income-producing assets are part of the stock-in-trade of a business which buys and sells those assets in the ordinary course of trade, such assets may form the "fruit" instead of the "tree" (the tree being the business as a whole) and any profits from realisation may thus be taxable.

**FULL-TIME WORKING DIRECTOR** — A term used, e.g., in anti-avoidance legislation directed against devices to reduce tax by setting up corporate bodies with directors who are essentially owners or controllers of the company with only nominal duties, but receiving substantial remuneration. In making restrictions to limit the scope for tax avoidance or reduction, the legislation may exclude a "full-time" or "executive" director from the restrictions. Such a director may also benefit from reliefs provided in the tax law for ordinary employees, but from which ordinary directors have been excluded.

**FUND, FIXED, FLEXIBLE, GO-GO, etc.** — See TRUST.

**FUSIE** — (Holland) Merger.

**FUSION** — (Germany) Merger.

**FUSION** — (France) Merger.

[to be continued]

## ERRATUM

### 1978/5, Page 232 Editor's note (footnote 3) on Indian income tax on purchases, United States: Foreign Tax Credit

The legal position has been reiterated in Circular of the Central Board of Direct Taxes No. 163 dated May 29, 1975 referring to Circular No. 23 dated July 23, 1969. It is stated that where there is a regular agency established in India for purchase of the entire raw materials required for the purpose of manufacture and sale abroad and the agent is chosen by reason of his skill, reputation and experience in the line of trade, it can be said that there is a business connection in India so that the non-resident is liable to income tax in India on a portion of the profits attributable to the purchase of raw materials in India required for the purposes of manufacture and sale abroad. However, the correct legal position is that in the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to purchase of goods in India for the purpose of export, even though the non-resident has an office or an agent in India for this purpose. (Clauses (a) and (b) of the Explanation to Section 9(1)(i) of the Indian Income Tax Act 1961.)

Where a resident person in India acts in the ordinary course of his business in making purchases for a non-resident person, he would not normally be regarded as an agent of the non-resident person. But, when the resident person in India is closely connected with the non-resident purchaser and the course of business between them is so arranged that the resident person gets no profits or less than the ordinary profits which might be expected to arise in that business, the Income-tax Officer is empowered to determine the amount of profits which may reasonably be deemed to have been derived by the resident person from that business and include such amount in the total income of the resident person.

# Cumulative Index 1978 ~ Nos. 1-9

# Contents

of the November 1978 issue



**In next issues:**

Compensation of expatriates transferred to Brazil
— by *Aleksas Juocys*

Hong Kong's new tax on offshore banking profits
— by *Y.C. Jao*

New measures reflecting inflation in the Israeli tax legislation
— by *Dr. J.F. Pick*

Canons of taxation and personal income tax in Nigeria
— by *A.C. Ezelue*

Malaysia: The Real Property Gains Tax Act 1978
— by *C.S. Yeoh*

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

# CONFERENCE DIARY

## DECEMBER 1978

*Management Centre Europe:* Multinational Compensation (including legal tax and accounting variations and their impact on financial appraisal of benefit decisions) (Round Table), Brussels (Belgium, December 4-6 (English).

*British Branch of I.F.A.:* Developments in French taxation, London (U.K.), December 7 (English).

## JANUARY 1979

*British Branch of I.F.A.:* Formation of Family Businesses, London (U.K.), January 9 (English).

*British Branch of I.F.A.:* The work of the OECD Fiscal Committee, London (U.K.), January 31 (English).

## FEBRUARY 1979

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

## MARCH 1979

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

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

*British Branch of I.F.A.:* Outward direct investment, London (U.K.), March 29 (English).

## SEPTEMBER 1979

*33rd Annual Congress of I.F.A.:* I. The Taxation of transfers of ownership on death or inter vivos gifts with special reference to the continuity of family-held enterprises; II. The effects of losses in one country on the tax treatment of the enterprise or group (provisionally). For the Seminars the following Subjects are suggested: Trends in income tax treaties involving developing countries, with special reference to the U.N. Group of Experts. Trends in Scandinavian Taxation. Copenhagen (Denmark) September 4-8 (English, French, German, Spanish).

## FEBRUARY 1980

*Business Perspectives:* 6th International Tax Conference. Singapore, February 408 (English).

FOR FURTHER INFORMATION PLEASE WRITE TO:

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

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

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

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

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

## ERRATUM

The article by Dr. Barry Bracewell-Milnes: "The future of personal taxation" in the May 1978 issue of the Bulletin contains two printing errors in Table 2 on pages 197:

1. The maximum percentage of the rate of 1976 tax for Finland should be 71.00 and not 77.00 (Column 1, Earned income)
2. This figure includes 20 percent local income tax and not 15 percent (Notes, line 2)

Please note that mistakes are due to a printing error for which the author is not responsible.

# Perspectives on Wealth Taxation*

by Richard M. Bird**

R.M. BIRD

The many words written about taxation over the centuries have not, it appears, dimmed the attraction of the subject. Ordinary citizens generally dislike taxes, especially those of which they are most aware, and at best view them as a painful necessity: nevertheless, they seem always to be fascinated by advice on how to avoid taxes and by tales of high "tax-free" living. Tax practitioners, such as lawyers and accountants, who earn their bread through the intricacies of the tax system of course have self-interest urging them on to further knowledge of at least some aspects of taxation. Economists turn to taxes not only for classroom examples of basic economic principles but also as favourite instruments to achieve this policy goal, or that, or perhaps both. And, finally, tax economists as a rule have all three motivations — curiosity (morbid or otherwise) as to the varied ways the human animal reacts under "tax stress", self-interest, and a concern with economic policy — urging them on to further study of the apparently endless ingenuity displayed by man in his unceasing efforts to tax his fellow man. No field of taxation rewards such study more than the taxation of wealth and property, nor does any better demonstrate the huge gap remaining between tax theory and tax practice in every country.

Both characteristics of wealth taxation -- its incredible complexity and variation from country to country, and the gap between theory and practice -- are accurate reflections of the history and the nature of taxes on wealth and property. Taxes on material wealth, especially on land, are among the oldest fiscal instruments in most countries. The varied collection of wealth taxes presently found throughout the world thus represents the result of decades, even centuries, of accretionary adaptation to the evolving social and political milieu. This history virtually guarantees that whatever exists will bear little resemblance to the sorts of wealth taxes long favoured by fiscal theorists. The many, often contradictory, aims assigned by economists, politicians, and bureaucrats to different parts of the wealth tax system in most countries similarly lead also to the observed results of complexity and a wide gap between the theory of taxing wealth and its practice.

Despite its antiquity wealth taxation has been relatively neglected in recent years. For some decades now the main efforts of fiscal reformers in most countries have been directed at the goal of making the income tax the keystone of the fiscal system -- in the first instance by "globalizing" it, [1] with the ultimate ideal being a truly comprehensive income tax. [2] More recently, some doubt has been cast on the attainability as well as the desirability of such a comprehensive income tax, even in the most developed countries, and a direct personal tax on expenditures has been put forth by some as an alternative ideal. [3]

The emphasis of fiscal writers on expenditure and income taxes, and their relative neglect of wealth taxes, is a fair reflection of the small and declining weight of wealth taxation in the fiscal system of most countries, high-income and low-income alike. [4] Indeed, the only discernible world-wide trend in the wealth tax field appears to be this decline in the relative importance of wealth taxes: there is no trace of any such convergence on details of structural design as one sees in the income and sales tax fields, for example.

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** Professor of Economics, Department of Political Economy, University of Foronto.

1. See Oliver Oldman and Richard Bird, "The Transition to a Global Income Tax: A Comparative Analysis", *Bulletin for International Fiscal Documentation*, 31 (No. 10, 1977), 439-454.
2. The most fully-realized statement of this ideal remains the *Report* of the Canadian Royal Commission on Taxation (6 vols.; Ottawa: Queen's Printer, 1966). For a detailed analysis of what happened to this ideal on its way to reality, see M.W. Bucovetsky and R.M. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal*, 25 (March 1972), 15-41.
3. See J.E. Meade et al., *The Structure and Reform of Direct Taxation* (London: George Allen and Unwin, 1978), and *Blueprints for Basic Tax Reform* (Washington: U.S. Treasury Department, 1977). Similar idead were put forth twenty years ago by Nicholas Kaldor, *An Expenditure Tax* (London: George Allen and Unwin, 1956), and applied by him to India in his *Indian Tax Reform* (New Delhi: Government of India, Ministry of Finance, Department of Economic Affairs, 1956).
4. On the high-income countries, see *Revenue Statistics of OECD Member Countries, 1965-1975* (Paris: Organization for Economic Co-operation and Development, 1977). On low-income countries, see R.J. Chelliah, H.J. Baas, and M.R. Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1969-71", *IMF Staff Papers*, 22 (March 1975), 187-205.

In recent years, however, a few authors have gone against the trend and suggested that a much more important role for wealth taxation is desirable, both in high-income countries [5] and in low-income countries. [6] The present paper, although it embodies no new research, is in part intended as a small contribution to the same cause: wealth taxes should, it is argued here, play a more important part than they now do in the revenue systems of most countries. In practice, however, for reasons brought out later, this outcome, however desirable in principle, seems most unlikely to come about in reality.

Several limitations on the treatment of these complex issues in this short paper deserve emphasis. In the first place, no attempt has been made here to survey the world scene systematically (although several such surveys have been carried out in recent years on particular forms of wealth taxes. [7] Secondly, to discuss all conceivable forms of wealth taxation would be a task not for one paper but for several books. This paper therefore focuses on death taxes and real property taxes, with only passing reference to other forms of wealth taxation. Finally, the term "wealth" as used here is identical to "property", that is, the legal ownership of assets. [8] It is therefore not identical to "capital" as conventionally used in economic analysis in large part because it excludes "human capital" (the value of the capital an individual "owns" in the form of his own physical and mental capabilities at any point in time). There has been some theoretical discussion of the possibility and desirability of taxing such human wealth, [9] but this paper is concerned solely with the taxation of non-human wealth both because that is all that is now taxed anywhere and because it is all that I think should be taxed. [10]

## THE GOALS-INSTRUMENTS APPROACH

The tendency of enlightened experts, when charged with designing fiscal instruments, is usually to assume some objective -- for example, the attainment of "horizontal equity" or of some given degree of income redistribution -- and then to appraise alternative designs in terms of how well they satisfy the assumed objective or goal. This instrumental approach to questions of tax design is a substantial improvement over the still common alternative approaches of copying either what was done in some other country or what appears in some textbook: indeed, I have elsewhere argued (with particular reference to Colombia) that designing the optimal tax system for any country, in fact, *requires* the adoption of such an instrumental perspective. [11] A possible danger with this approach, however, is that one may become so engrossed with some particular end that one forgets that any specific tax measure as a rule affects not one but many ends.

Advocates of wealth taxation are commonly accused of making precisely this error by those who oppose such taxation -- in particular, they are said to be seeking "equity" at the expense of "economic growth". Those who argue this way often appear to think that merely raising this possible conflict is sufficient to make their point. Such is not the case, however. There is no reason to expect there to be a simple "trade-off" between these two vaguely-defined goals of "equity" and "growth": rather, the two are generally interdependent in some complex fashion that cannot be satisfactorily analyzed without at least the implicit quantification of all relevant goals and of the effects of various tax (and other) instruments on their attainment. [12]

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5. See, especially, Lester C. Thurow, "Net Worth Taxes", *National Tax Journal*, 25 (September 1972), 417-423.
6. Although Alan A. Tait, *The Taxation of Personal Wealth* (Urbana: University of Illinois Press, 1967), does not explicitly discuss developing countries, his conclusion (p. 202) makes it clear that the case for wealth taxation is especially strong there. The 1962 Santiago Conference on Latin American fiscal policy also favoured more effective wealth taxation *(Fiscal Policy for Economic Growth in Latin America,* Baltimore: Published for the Joint Tax Program by the Johns Hopkins Press, 1965, p. 421). See also R.M. Bird, "Public Finance and Inequality", *Finance and Development*, 11 (March 1974), 2-4.
7. In addition to Tait; see R.M. Bird, *Taxing Agricultural Land in Developing Countries* (Cambridge: Harvard University Press, 1974); George E. Lent, "The Urban Property Tax in Developing Countries", *Finanzarchiv,* N.F. 33 (Band 1, 1974), 45-72; Roy W. Bahl, "Urban Property Taxation in Developing Countries", Paper presented to Committee on Taxation, Resources, and Economic Development, Cambridge, Mass, Oct. 22-24, 1976 (Mimeo.); and Noboru Tanabe, "The Taxation of Net Wealth", *IMF Staff Papers,* 16 (March 1967), 124-166.
8. Compare Tait, pp. 2-4.
9. See Earl R. Rolph and George F. Break, *Public Finance* (New York: Ronald Press, 1961), p. 196, and Break and Ralph Turvey, *Studies in Greek Taxation* (Athens: Center of Planning and Economic Research, 1964), pp. 175-177.
10. I agree fully with the reservations about taxing human capital expressed by Richard Goode *(The Individual Income Tax,* rev.ed.; Washington: The Brookings Institution, 1976), p. 21 n: ". . . . I do not think that human capital can be measured with the degree of accurary that is properly demanded for taxation. Furthermore, I see dangers of infringement on personal liberties in applying a tax on the present value of potential earnings: Would a person with great earning capacity who refused to work enough to earn the money to pay his tax be sent to jail?" Moreover, especially in developing countries, one policy aim should probably be to favour the accumulation of human wealth. Despite the doubts cast on the efficacy of education as a redistributive agent in advanced countries in recent years, I agree completely with the distributional desirability of expanding education in most developing countries as argued strongly for Colombia in a recent study by Albert Berry and Miguel Urutia (Income Distribution in Colombia, New Haven: Yale University Press, 1976), Chap. 8.
11. See Bird, "Optimal Tax Policy for a Developing Country: The Case of Colombia", *Finanzarchiv,* N.F. 29 (Feb. 1970), 30-53. It should be noted that the present paper is for the most part concerned with tax *design* rather than the more practical (and often more difficult) question of tax *reform:* for a discussion of the difference, and some proposed "rules for reformers", see Bird, "Tax Reform and Tax Design in Developing Countries", *Rivista di Scienze Finanziario e Diritto Fiscal,* 36 (No. 2, 1977), 297-306.
12. An outstanding (and depressing) feature in almost all countries is the very poor quality of the information available on the size and nature of wealth-holdings, particularly towards the upper end of the distributional scale. This data deficiency makes explicit quantification almost impossible in this field. Nevertheless, what little information is available (mostly in the United States, Britain, and Canada) appears to support the general line taken here, namely, that the inequality of wealth distribution is a serious problem and that the tax system can do much more than it now does to redress this problem. For a useful introductory discussion of

Even the formal solution of such problems at present generally lies far beyond the capacity of public finance economists, except under the most stringent (and unrealistic) conditions. [13] The value of approaching the design of tax structures in this way thus lies not in the answers it yields but rather in the useful perspective it provides on the proper task of public finance research. In the case of wealth taxes, as in many other instances, Carl Shoup was on sound ground when he argued that "the conflicts usually cited arise not because the goals are inherently incompatible but because the instruments assumed available are too few, or their values too constrained, or their effectiveness zero or negative for certain ranges of their values". [14] One main task of the wealth tax designer is therefore to eliminate or reduce the apparent conflict of goals, either by inventing new tax instruments -- and in no field have more novel taxes been designed, at least on paper [15] -- or, perhaps more realistically, by putting the appraisal of wealth taxes in the context of the tax system as a whole.

Within this general framework, the broad goals usually assigned to wealth taxes include the following:
(1) to complete the income tax system; [16]
(2) to tax wealth in its own right;
(3) to achieve certain social goals;
(4) to achieve certain economic goals; and
(5) to produce revenue.

Each of these objectives requires careful and detailed elaboration in order to see how they should affect the design and structure of an ideal wealth tax system for any particular country: all that can be done here, however, is to review them briefly in general terms.

## WEALTH AND INCOME TAXES

Wealth taxes may be viewed as complements to income taxes in two senses: administratively and structurally. No income tax in the world is perfectly administered, and most are particularly deficient with regard to taxing income from capital. [17] Even the best-run and most comprehensive income taxes do not tax accretions to wealth (capital gains) as they accrue, and most income taxes do not tax accrued gains if the property is held until death. Some substantial wealth-holders also report such low incomes that it is generally felt that subjecting them to income taxes alone is not enough. [18]

In general, then, wealth taxation may in part be justified as making up for recognized but practically unavoidable defects in income taxes. An annual tax on net wealth, taxes on inheritances and gifts, and even such a crude gross wealth tax as the real property tax have all been supported at times on these grounds -- the last-named, for example, as a means of making all those with "a stake in the community" (as measured by their property-holdings) contribute to the support of public functions, particularly at the local level. [19]

A more refined line of argument is that an income tax that treats income from all sources equally, as a true "global" income tax is supposed to do, is in fact unfair because income earned by labour is in a sense less "pure" (or net) than income earned from capital (e.g. because of the lack of explicit provision for the costs of acquiring and maintaining "human capital"). Furthermore, income from wealth is compatible with leisure in a way income from labour clearly is not and also has more "lasting power" in the sense that it does not depend on the continued ability of the taxpayer to put forth effort. This line of throught has led many income tax systems to distinguish between earned and unearned income either through applying different rate structures or by granting special credits or allowances to the former. [20] The same arguments may also be used, somewhat more tenuously, to support an annual tax on the stock of capital as opposed to a tax on the annual flow of income from it or a tax, regular or irregular, on increases in its value.

A better case for an annual wealth tax can be made in its own right, however. The possession of wealth, it may be argued, carries with it a degree of security, independence, influence, and social power that is not adequately measured by the flow of realized money income to which it gives rise. Income and wealth are not simply alternative ways of measuring the same reality (with different time subscripts). In particular, the taxation of income -- always in practice a partial tax, if only because leisure is excluded from the tax base -- cannot adequately substitute for the taxation of wealth. Wealth thus contitutes, at least to some extent, an independent tax base that is appropriately tapped by an annual tax on net wealth.

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the data, the issues, and possible reforms (in Britain), see A.B. Atkinson, *Unequal Shares* (Penguin Books, 1974).
13. Carl S. Shoup, *Public Finance* (Chicago: Aldine, 1969), Chap. 19, provides a good introductory discussion of this subject.
14. Shoup, p. 480.
15. See, for particularly interesting examples, Tait, Chaps. 10 and 11 on the Rignano plan and Vickrey's "bequeathing power" succession duty, and Meade et. al., Chaps. 15 and 16 on such esoteric forms of transfer and wealth taxation as PAWAT (progressive annual wealth accessions tax).
16. Actually (as discussed extensively in the Meade report) adequate wealth taxes are even more necessary to complete an expenditure tax system, but this aspect is not further discussed here.
17. For a catalog of some of the problems in this respect, see Oldman and Bird.
18. See, for example, the data on large cattle ranchers in Colombia reported by Quale in R.A. Musgrave and M. Gillis, *Fiscal Reform in Colombia* (Cambridge: Harvard Law School International Tax Program, 1971), p. 418. Colombia's new presumptive income tax, based on net worth data, is in effect an attempt to get around this problem: it is of course not a true income tax at all but rather a variant form of wealth taxation.
19. This line of argument is not uncommon: for a particularly explicit recent example, see Committee on the Reform of Property Taxation in Ontario, *Report* (Toronto: Queen's Printer, 1977). One danger of relying too heavily on this sort of argument to support wealth taxation is suggested by the recent Canadian experience in which introduction of the constructive realization of capital gains at death was accomplished only at the expense of abolishing the federal death tax: the complicated story is told in detail in Bird and M.W. Bucovetsky, *Canadian Tax Reform and Private Philanthrophy* (Toronto: Canadian Tax Foundations, 1976), Chap. 3.
20. See Bird and Oldman, p. 441.

## THE SOCIAL CASE FOR TAXING WEALTH

None of the above traditional arguments really considers wealth taxes as instruments to achieve any goal other than an allocation of the tax burden that will be considered socially acceptable, or "fair". This is of course an important goal in its own right, but most of the arguments both for and against wealth taxes really focus on the alleged relation of these taxes to other social and economic goals. It is in this larger arena that most of the verbal battle over such taxes takes place, with proponents touting their social and economic virtues and opponents denigrating them. Economists are not particularly well-trained to sit as judges in this battle, because most players on both sides base their cases on value judgements rather than on empirical evidence or economic theory. Nevertheless, a brief review of some of the key points at issue is necessary -- if only to show the reader where I stand!

The existing distribution of assets in a country at any point in time is largely the outcome of historical accident, as condoned by the state and frozen in law. The result of this pattern of distribution in initial wealth is that many of those successful in life stand not on their own feet but on the shoulders of their fathers -- a result hardly in accordance with the commonly-accepted idea that one function of the state is to provide relatively equal access to economic opportunity for its citizens. [21] "Equality of opportunity" is admittedly a rather fuzzy concept, [22] but there can be little question that its attainment, however attenuated in practice, is a legitimate goal of public policy in all democratic countries. Life may indeed be a lottery — and it is well-known that people accept both the legitimacy of there being big winners in a lottery, and the need for there to be some big prizes to keep people participating — but if there is one thing known about those who take part in lotteries it is that they must believe the lottery is fairly run. In these terms, one role of the state is to improve the fairness of the lottery of life: and one way to do so is through direct taxation of inherited wealth.

The chosen tax instrument for this purpose would appear to be a virtually confiscatory tax levied at the time when accumulated wealth is passed from the original accumulator to someone else by gift or bequest. The tax should clearly be levied on the heir (or donee), not on the estate as such. It should also probably be graduated in accordance not only with the amount transferred on any one occasion but also with the total amount of such transfers received by any individual throughout his life -- in other words, it should be some form of "accessions tax". [23] Furthermore, there seems no reason for there to be any favouritism at all to close relatives. On the contrary, since they are the recipient of most gratuitous transfers, they are also those to be most burdened, in the name of increased equality of opportunity, by this tax. Finally, there is no way in which even full taxation of bequests and gifts under the income tax can achieve this goal. Indeed, high income taxes in themselves are somewhat perverse in their effects if they are considered to replace taxes on inherited wealth as such: since income taxes make it harder for new entrants to breach the charmed circle of the already wealthy, they tend to perpetuate rather than diminish existing inequalities. To say this is not, of course, to argue against high income taxes but rather to make again the point that income and wealth taxes are different fiscal instruments, with (to some extent) different objectives.

The other major social argument for wealth taxation leads to rather different conclusions about the optimal design of a wealth tax structure. It is well known that wealth is considerably more concentrated than income in all countries with substantial private sectors. This concentration of wealth in relatively few hands may be considered socially undesirable for a number of reasons. Great inequality may be considered unlovely in itself. Or it may be thought to represent an actual or potential danger to the economic or political system -- for example, through the ability of a few rich families to export capital in economic crises or to extend massive financial support to politicians or officials sympathetic to their interests. [24] The oft-mentioned fact that spreading the wealth of the few among the many would have little visible effect upon the well-being of the latter, while true given the relative numbers of the two groups, is irrelevant since the social goal is to make the rich less powerful, not the poor richer. This case for direct redressive taxation of wealth thus rests basically on the desire to mitigate the undesirable political and social effects of the distribution of wealth arising from the system of private property. [25]

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21. The more fortunate members of society also benefit substantially from the human capital invested in them when they are young: reducing initial disparities in material wealth would do little to rectify this imbalance but it would at least prevent matters from being even worse. Even if taxing material wealth encouraged still more investment by the wealthy in (non-taxable) human capital, "the social gain from the rapid accumulation of human wealth could be an offsetting factor" (John Brittain, *The Inheritance of Economic Status*, Washington: The Brookings Institution, 1977, p. 7).

22. For an extended discussion, see K. Klappholz, "Equality of Opportunity, Fairness and Efficiency", in M. Peston and B. Corry, eds., *Essays in Honour of Lord Robbins* (London: Weidenfeld and Nicolson, 1972).

23. See C. Sandford, J. Willis, and D. Ironside, *An Accessions Tax* (London: Institute for Fiscal Studies, 1973), and W. Andrews, "The Accessions Tax Proposal", *Tax Law Review*, 22 (1967), 509.

24. The existence of corporations has perhaps weakened the potential evils of highly concentrated personal wealth somewhat, especially in high-income countries, but it hardly eliminates the problem. It should perhaps be noted, as Arthur Okun *(Equality and Efficiency: The Big Tradeoff,* Washington: The Brookings Institution, 1975 p. 30) has argued, that societies concerned with the use of money to acquire power, particularly political power, can and should formulate and enforce specific rules to prevent money being spent in ways considered undesirable. Nevertheless, the importance of large blocks of wealth, whether spent or not, must not be underestimated, and it would seem wise to support such rules by taking away some of this potential power through wealth taxes.

25. In all fairness it should be noted that much of the problem being discussed here results from various state actions that created monopolies and privileged positions in the first place. A "first-best" approach might be to alter these policies directly, but in the nature of the policy process the "first-best" is not always possible and one must fall back on such second-best policies as redressive taxation.

In principle, the ideal way to deal with the problems supposedly arising from the undue concentration of wealth might be to reallocate that wealth directly through such devices as confiscation or a true capital levy. [26] In practice, such drastic steps have been ruled out in most countries so the relevant question for policy designers becomes: what fiscal instrument, short of confiscation, will best reduce the (presumably) excessive concentration of wealth? One tax indicated by this criterion would appear to be a death tax levied at high rates on large estates, even when left entirely to close relatives: the tax base is now determined not by how much is left to any one person but by the size of the total estate.

The possible alternative of an inheritance tax with steeply graduated rates according to the size of the legacy is less desirable, because most of the alleged evils of concentration remain even when formal legal title is divided among a number of heirs. The root of the problem is the size of the estate itself, so it is that which must be taxed. Annual net wealth taxes, capital gains taxes, taxes on capital income, and, in short, all levies which restrict the freedom of people to accumulate assets as they see fit (and the economic system permits), also of course have a role to play in diminishing the build-up of such large masses of wealth in the first place. But short of a revolution the only feasible fiscal instrument that can be aimed explicitly at wealth concentrations in most countries appears to be a high-rate estate tax.

This line of discussion usually gives rise to two sorts of objection: philosophical and economic. The more important of these, in my view, is the philosophical: to some people, the inequality of wealth (and income) is an ugly, unnecessary, and undesirable accretion on the social and economic system; to others, it is a reflection of the inevitably unequal abilities of men and of the just distribution of rewards in the market economy. [27] Put another way, some believe that property is, in the final analysis, a creation of the state -- a privilege granted by the community, not a natural right. [28] Others believe that the possession of property is a natural intrinsic right of man and that family wealth is a dynastic trust, the perpetuation of which is in the national interest. There is clearly no easy way to reconcile these opposing views -- or the many variants of them that may be found in the literature. [29] There are no simple answers to the age-old question of what is a just or equitable distribution of income and wealth, and it it, in the end, this question that governs what a society does to achieve such possible social goals as reducing the concentration of wealth.

## ECONOMIC ASPECTS OF WEALTH TAXATION

I emphasize this point because it has always struck me as odd that the only arguments vaguer and more nebulous than those used to support wealth taxation on social and equity grounds are those used to attack it on economic grounds. My own view is that " . . . . . the treatment of death taxes [, and,] for that matter, other wealth taxes, is a good barometer of prevalent social and political attitudes toward the various dimensions of equality, and most of the economic arguments customarily trotted out in these discussions deserve little weight." [30]

Undoubtedly, the most politically potent argument against wealth taxes is that they deter private saving and investment. One variant of this view is that the freedom to dispose of one's property is a necessary incentive to the accumulation of capital: restricting this freedom through taxing wealth, even at death, will, it has been argued, deter saving and investment tremendously. This is at best a highly oversimplified view. The desire to accumulate wealth springs from many sources -- desire for power, fame, or income, for example, or the desire to accumulate for the sake of accumulation, or to pass on wealth to one's heirs, or to maintain and increase the family fortune. It is likely that all of these motives are at play simultaneously within the population as a whole, and several within any particular individual. Although all this makes the analysis of the effects of wealth taxes on economic behaviour even more obscure and difficult than the analysis of income taxes, the consensus of most economists appears to be that most wealth taxes -- whether low-rate taxes levied annually or high-rate taxes levied at death -- are unlikely to have much effect on the work / leisure choice, the savings / consumption choice, or the choice of what sorts of assets to acquire.

Although "overall, there are no determinate statements that can be made about the effects of wealth taxes," [31] it is perhaps worth noting that wealth taxes seem likely to have less adverse effects on incentives than income taxes of equal yield paid by the same people. [32] Indeed, since wealth taxes constitute a heavier burden on low-yielding than on high-yielding assets, they should in principle act as a stimulus to utilize assets more pro-

26. Actually, as Tait, Chap. 6, discusses, many capital levies have not been "true" in the sense of one-time, unexpected levies-- and those which have been surprises seem often to have been rather inequitable, certainly in intergenerational terms.

27. For a strong statement of the latter view, see Richard Wagner, *Inheritance and the State* (Washington: American Enterprise Institute for Public Policy Research, 1977).

28. This is basically the position of A.C. Pigou, *A Study in Public Finance* (3rd ed., rev.; London: Macmillan, 1947).

29. Richard and Peggy Musgrave, *Public Finance in Theory and Practice* (rev. ed., New York: McGraw-Hill, 1976), p. 85, list eight different criteria for deciding what constitutes a just state of distribution: (1) Keep what you can earn in the market; (2) Keep what you could earn in a competitive market; (3) Keep labour (earned) income only; (4) Keep what you could earn in a competitive market, given equal position at start; (5) Maximize total welfare; (6) Maximize average welfare; (7) Set a floor on welfare with the endowment rule (keep what you earn) applicable above it; (8) Maximize the welfare of the lowest group. Other criteria -- equally incompatible with each other -- could no doubt be devised.

30. Bird, "The Case for Taxing Personal Wealth", in Canadian Tax Foundation, *Proceedings of 23rd Tax Conference 1971* (Toronto, 1972), p. 16. (Some of the other arguments in the present paper may also be found in this article.)

31. Tait, p. 193. The more detailed discussion in Shoup, Chap. 14, leads to a very similar conclusion.

32. This is especially true of death taxes, the revenue from which (even when poorly administered) generally constitutes a substantial fraction of the total direct taxes paid by the richest citizens. (Incidentally, if one thinks that rich men are successful because they work hard it seems probable that an income tax is more likely to discourage them from so working than is the prospect of an equivalent tax at death.)

ductively: this idea has been exploited extensively in the literature on agricultural land taxes [33] and to a lesser extent with respect to the pervasive underutilization of industrial equipment in developing countries, [34] though once again there is no empirical evidence worthy of the name in any country. Nevertheless, it seems fairly safe to say that there is as good (or bad) an economic case for as there is against wealth taxes. [35]

Two other economic aspects of wealth taxation often give rise to concern: the first is their effect on small family-owned businesses and the second is their effect on international capital flows. The alleged effects of death taxes, in particular, on family businesses seem greatly overdone in practice. [36] Moreover, in principle it is important to recall that what effective death taxes destroy is not productive capital but the maintenance of family fortunes through the generations: taxes affect real capital only through their effects on saving and investment -- the indeterminateness of which has already been noted. Furthermore, "family ownership often means family management, and there is all too often good reason to believe that entrepreneurial genius is not genetically derived". [37] Indeed, from the point of view of the country, it might be a good thing if death taxes did in fact force changes in the management and ownership structure of many more companies than in fact they seem likely to do. [38]

At this point it may be appropriate to note that none of the arguments mentioned so far provide any basis at all for one common feature of the structure of taxes on wealth transfers -- the differentiation of rates in accordance with the relationship between donor and donee. Invariably in such systems the rates applied to spouse, children, and other immediate family members are much lower than those applied to more distant relatives and strangers. The result of this system is that the more an estate is left concentrated in the hands of direct descendants, the lighter the tax will be -- an outcome which is directly contrary to several of the possible reasons for taxing such transfers in the first place. Since the natural propensity of people is to leave most of their wealth to their direct heirs anyway, such provisions often reduce the effective rates to very low levels on most transfers.

One possible rationale for thus emasculating this important part of the wealth tax system is simply that policymakers agree with the dynastic concept of the family. Another -- to recognize adequately the contribution and needs of the spouse and minor children -- explains permitting tax-free transfers to spouses but not to children who have reached the age of majority. A final possible rationale is that at least in part the tax is really intended to tax "windfalls", that is, accretions to wealth which, because of their unexpected nature, are considered to reflect a particularly high degree of "ability to pay", e.g., the bequest received by a distant relative or a stranger. Presumably the idea is that because the bequest was unexpected, the incentive effects of taxing it will be minor -- although it is not clear that this argument holds for the testator also. [39] In any case, the "windfall" argument, despite its apparent influence on tax structures in many countries, seems very weak.

The other economic aspect of wealth taxes mentioned above as giving rise to some concern was their effects on capital flows. This is indeed a potentially serious problem. Any tax on capital may in theory induce sufficient internationally mobile domestic capital to migrate (and foreign capital to stay out) until the overall rate of return on capital has risen by enough to offset the tax -- in other words, until the tax has been shifted to consumers or less mobile factors of production. This argument presumes that a uniform rate of return on capital is set by international market forces -- surely a considerable oversimplification of reality -- and depends on other restrictive assumptions common to two-sector general equilibrium models. [40] Nevertheless, there is probably some truth in the view that wealth taxes may affect international capital flows in an undesired fashion. Although any such effects are likely to be small in the context of all the factors affecting such flows in any country and could presumably be offset if desired (e.g., by marginal exchange rate changes), this problem probably precludes imposing really drastic wealth taxes in the absence of an effective exchange control system. Even much less than drastic taxes have often been lowered on these grounds to what may be labelled an internationally competitive or "least common denominator" level. The increasing interdependence of today's world thus limits the role of redistributive fiscal policy by encouraging the establishment of such "least common denominator" tax systems,

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33. As Bird, *Taxing Agricultural Land*, p. 206, concluded: an "important argument for land taxes . . . may simply be that they encourage the more efficient utilization of land . . . ."
34. See especially S. Cnossen, *Excise Systems* (Baltimore: The Johns Hopkins University Press, 1977), Chap. 6, and references cited there.
35. This discussion does not attempt to deal with the sorts of arguments against taxing capital (and capital income) developed in recent years by such writers as Boskin, Feldstein, and Stiglitz (see, for example, the papers in *Journal of Political Economy*, 86 (April 1978), Part 2). My general position on these arguments is (1) that some of the assumptions on how markets function seem not very applicable in most developing countries and (2) that the taxes on personal wealth on which the present discussion is focused are so small in the total picture that any undesired impact on saving and growth can fairly easily be offset by adjustments elsewhere. Clearly, however, these arguments require much more systematic evaluation in any country before one can judge whether it is safer to thus ignore them.
36. The Canadian evidence on this subject, which seems as bad (or good) as that in any other country, is reviewed in Bird, "The Case for Taxing Personal Wealth", pp. 20-21.
37. Ibid., p. 30.
38. If one is worried about foreign takeovers of locally-owned firms, more direct measures can and should be taken to deal with the problem.
39. Some of the literature seems rather confused on this matter. When discussing the effects of death taxes in general, for example, the disincentive to save for the testator (assumed to accumulate in order to leave an estate) is stressed while the incentive to save for the heir (owing to lower expectation of wealth) is ignored. On the other hand, when discussing the structure of death taxes -- the consanguinity rules -- the effects on heirs are stressed and those on the testator are ignored.
40. For some cautions on the use of this type of analysis in the design and appraisal of tax policy, see Bird, "Comentarios", in: *La Politica Tributario como Instrumento de Desarrollo* (Washington: Organization of American States, 1973), 404-414.

pressing lightly on capital and the well-to-do who have many more avenues of escape than the less mobile poor. [41]

## THE REVENUE DIMENSION

The final goal explicitly attained by wealth taxes is of course to produce revenue. In most countries, as already noted, the taxes on personal wealth -- the net wealth tax and death taxes -- to which most attention has so far been given in this paper do not in fact produce much revenue in aggregate. This fact, used by some as a reason why the taxes in question might as well be abolished, has been turned into a virtue by others who have argued that this small revenue yield means that even the most drastic effects of such taxes on saving, investment and other aggregate economic magnitudes will be so small as to be invisible in the larger picture. [42] If has also often been noted that the revenue yield of these taxes is anyway irrelevant to their main purposes -- that is, to supplement the income tax and to regulate the distribution of wealth. Indeed, if, for example, heavy death taxes were fully successful in breaking up large estates no revenue would be collected from them at all.

What has been less often noted, however, is the potential importance of the contribution to total tax progressivity of even small wealth taxes that, however defective their administration, are paid almost exclusively by the richest group in society. A recent study of Bolivia, for example, found that even the very weak death taxes in that country probably collected a significant amount of revenue from the top 1 or 2 percent of the population -- and suggests that this tax probably constituted a significant fraction of the total personal taxes paid by this select group. [43]

What this means is that taxes on personal wealth, even though their aggregate revenue yield is usually small (and inelastic), may constitute a very important part of the total taxes paid directly by the wealthiest people in the country. Insofar as the task of the tax system is to make the rich relatively poorer, wealth taxes thus have an important role to play.

The main revenue yielded by wealth taxes in all countries, however, comes not from taxes on personal wealth but from taxes levied on gross wealth held in the form of real property. [44] The principal goal sought through taxing property is indeed simply to produce revenue, especially for local governments. Once again, however, this simple objective has often been lost sight of when it is realized that in principle property taxes can be so structured as to produce many desirable (or undesirable) effects. I have elsewhere discussed such matters at length with respect to rural land taxes. [45] Many others have done the same for urban property taxes. [46]

Although this discussion is not repeated at length here, the dictum that form should follow function is, it appears, as true in the field of property taxes as in that of the death taxes discussed above. In both cases, the probable result of careful consideration of the desirable design of tax structure is likely to be a relatively complex structure with different features intended to further different goals, some of which are superficially in conflict with each other. An example from the field of property taxation might be features to encourage building (e.g. higher taxation on land than on buildings) side by side with a set of user-charges based on particular characteristics of buildings (their height, floor area, etc.) and hence in effect amounting to a special tax on buildings. [47] Each feature has the effect of moving the system towards one goal (e.g., more building) and away from another (e.g., rational determination of the level and distribution of urban public services). [48] So long as the combination of the two results in net progress towards both goals, however, there is not necessarily any real conflict between them. [49]

## KNOWLEDGE AND POLICY

This point returns us to the goals-instruments approach with which this discussion began. Matters cannot be left so neatly rounded-off, however, for it must also be reiterated that the trouble with this approach is that we simply do not know to what extent most tax measures move us toward (or away from) any particular goal. I asserted earlier that most people's judgements of both the proper level and structure of wealth taxes depended more on faith (philosophy) than on economic reasoning. What I am saying now is that most of the relevant economics also depends in the end more on faith than on knowledge. What we are really concerned about are usually the values of such critical parameters as the elasticity of saving to changes in the rate of return on

41. This argument is elaborated in Bird, "The Tax Kaleidoscope: Perspectives on Tax Reform in Canada", *Canadian Tax Journal,* 18 (Sept.-Oct. 1970), 471-472.
42. Cf. Bird, "The Case for Taxing Personal Wealth", pp. 16-17.
43. R.A. Musgrave et al., *Fiscal Reform in Bolivia* (Cambridge: Harvard Law School International Tax Program, forthcoming), Chap. 15. Although, as we might expect, the data were very weak, a comparison with the income tax data in *ibid.*, Chap. 13, suggests that death taxes probably constituted a significant fraction of the total income and wealth taxes paid by the upper end of the taxpaying population.
44. The corporate income tax may also be considered a tax on wealth (held in the corporate form), but this tax is not further discussed here.
45. Bird, *Taxing Agricultural Land.*
46. A useful collection of papers is Arthur P. Becker, ed., *Land and Building Taxes* (Madison: University of Wisconsin Press, 1969).
47. Such schemes are discussed, for example, by W.S. Vickrey, "General and Specific Financing of Urban Services," in H.G. Schaller, ed., *Public Expenditure Decisions in the Urban Community* (Baltimore: Johns Hopkins Press, 1963).
48. This point is elaborated in Bird, *Charging for Public Services* (Toronto: Canadian Tax Foundation, 1976), Part 3.
49. As Carl Shoup put this point in a review of several earlier reports on Colombian fiscal reform: " . . . . if one instrument moves the economy toward goal A only at the cost of moving it away from goal B, there can usually be found another, contrary-acting instrument, that will move the economy toward goal B faster than the first instrument moves it away, while moving it away from goal A more slowly than the first instrument moves it toward that goal" (Shoup, "Three Fiscal Reports on Colombia: A Review Article", *National Tax Journal,* 26 (March 1973), 62).

capital and the savings response to changes in death taxes -- and we have almost no useful or reliable evidence on such matters, certainly not in developing countries.[50]

Despite the wealth of words devoted for centuries to the subject of wealth taxes, almost no empirical research has been devoted to them even in the countries where they have existed longest -- and that little is inconclusive. Nothing illustrates this point better than the recent inconclusive debate on the incidence of the property tax. Whether this tax is considered to be progressive or regressive has been shown to depend on who is asking the question, and why.[51] Colombia, for example, has been fortunate in having an exceptionally careful study of this subject (recently by Johannes Linn).[52] This study concluded that the tax was probably, for most practical policy purposes, progressive,[53] but this conclusion inevitably rests on rather thin data and is no better than the assumptions underlying it.[54]

This inevitable weakness in the empirical basis for most refined policy proposals reinforces the advice of those most acquainted with the practical side of taxation in developing countries: keep it simple! This advice is particularly valid in the case of wealth taxes because of the fundamental difficulty of determining the tax base.

## THE ADMINISTRATIVE CONSTRAINT

The simplest case is again that of real property. In one sense, the taxation of real property should be relatively easy, since the object of taxation is not only visible but immovable. In another sense, however, such taxation is extremely difficult because of the problems in valuing it satisfactorily: no two parcels are identical; for many classes of property there are relatively few transactions, and even they are often not very representative; owners have a direct financial interest in under-valuation which makes reliance on either self-assessment or official assessment risky -- the latter because of the susceptibility of usually low-paid assessors to corruption.[55] Even when well and honestly run, real property valuation is as much an art as a science. Like all arts, appraisal of its results is therefore invariably rather subjective.

Despite these and other problems, it is, as many countries have demonstrated, perfectly feasible to operate a satisfactory tax on real estate -- at least provided the tax is relatively low-rate and uniform, without very sharp differences in effective rates among and within classes of property.[56] The weaker the administrative apparatus the simpler the tax should be if it is to operate successfully. Complex taxes run by poor administrations tend to produce inequitable and often allocatively undesirable results. For this reason, a recent study concluded that "the road . . . . . to more effective agricultural land taxes in particular lies in a simple, even crude valuation technique and tax structure (rather than the more complex taxes often proposed) . . . . a simpler levy is more likely to result in acceptable and desirable results than a more complex one".[57] This advice does not necessarily preclude such relatively simple structural devices as the examption of low-valued properties,[58] but it does suggest that very refined proposals, e.g., to deter land speculation through carefully-structured land taxes, stand little chance of success.[59]

There is a substantial carryover from this discussion of the interdependence of land tax structure and administration to the taxes on personal wealth discussed earlier in this paper because in all countries the easiest component of personal wealth to tax -- and thus, one suspects, the component that is in reality the most heavily taxed, even under allegedly general wealth taxes -- is real property. There are essentially two administrative problems in wealth taxation: the first is to locate the assets, and the second is to value them.[60] On both grounds, real property, whether business or personal, is the easiest asset to deal with. All other assets -- personal property,

50. Michael Boskin ("Taxation, Saving, and the Rate of Interest", *Journal of Political Economy,* 86 (April 1978), 53-527) has recently shown that most previous estimates of tax effects on savings are very weak, and has put forth considerably higher estimates based on his own work. It is not yet clear, however, how well the latter will stand the test of time, and further research.

51. The best introduction to the discussion is probably Henry Aaron, *Who Pays the Property Tax?* (Washington: The Brookings Institution, 1975). See also Bird and N.E. Slack, *Residential Property Tax Relief in Ontario* (Toronto: University of Toronto Press, 1978), Chaps. 3-5.

52. Johannes F. Linn, "The Incidence of Urban Property Taxation in Developing Countries: A Theoretical and Empirical Analysis Applied to Colombia", World Bank Staff Working Paper No. 264 (August 1977).

53. It should be noted that this progressivity is what may be called "blind progressivity", that is, the tax may be distributed in a progressive fashion by income groups but the actual burden borne by any person is "blind" to his personal circumstances and therefore need not accord with accepted equity standards. Since many studies have shown that the within-class variance of taxes may exceed the between-class variance, this point is not unimportant (see Bird and Slack, pp. 59-60, 73).

54. A detailed exposition of the formidable array of necessary assumptions is provided by Charles E. McLure, Jr., "The Relevance of the New View of the Incidence of the Property Tax in Developing Countries", Paper presented to Committee on Taxation, Resources, and Economic Development, Cambridge, Mass., Oct. 1976.

55. Occasionally writers, including some in Colombia, have become very enthusiatic about the possible advantages of clever self-assessment systems, but I see no reason to change an earlier judgement that such schemes offer no shortcut to effective tax administration (Bird, *Taxing Agricultural Land,* pp. 243-246).

56. A useful detailed discussion of the requirements for a workable property tax is Lyle C. Fitch, "Concepts and Administration of Taxes on Property", in Joint Tax Program, *Problems of Tax Administration in Latin America* (Baltimore: Johns Hopkins Press, 1965).

57. Bird, *Taxing Agricultural Land,* p. 294.

58. Linn, p. 90. Indeed, considerations of administrative cost support this recommendation -- though one must always be very careful when drawing any line between what is to be taxed and what is to be exempt.

59. For a relatively pessimistic review of the possibilities along these lines, see R.S. Smith, "Land Prices and Tax Policy", *American Journal of Economics and Sociology,* 36 (Oct. 1977), 337-350 and 37 (Jan. 1978), 51-69.

60. The third administrative problem, of course, is to collect the taxes. It is assumed here, perhaps optimistically, that this can be done -- although in reality the feasibility of collection no doubt itself depends in part on the political acceptability of the valuation process.

assets abroad, securities, cash, family businesses -- tend to be much harder to locate and (usually) to value, once located. Even when such assets as automobiles and (non-bearer) securities are registered, it is often a formidable administrative task to bring together the information bearing on a particular taxpayer in one place.

For these reasons, then, it seems fair to say that the viability of net wealth and death taxes rests at base on the existence of an adequate and up-to-date real property valuation system. Beyond this, perhaps the most important administrative component of a wealth tax system is the development of a small core of experts to deal with such complex problems as the valuation of closely-held businesses. Even if the limited technical resources available in most countries can be profitably directed to such activities, however, in practice most wealth taxes will probably amount to relatively little more than an additional "personalized" tax on real property. To say this is not to denigrate the potentially real value, social and economic, of such taxes: but it does suggest, in line with the earlier discussion, that it would probably be a mistake to strive for a great deal of refinement in the design of a tax structure that at base is effectively limited to a limited class of assets.

## CONCLUSION

This paper has covered, admittedly superficially, a vast area. It may, however, be summed up in a relatively few propositions. In the first place, there is a strong case on social and equity grounds for taxing wealth as such. In fact, different arguments support all of the separate levies on wealth found in the world: the annual net wealth tax (equity); taxes on inheritances and gifts (equity and social); and the property tax (revenue). Both the place of wealth taxes in the tax mix and of the various forms of wealth tax in the wealth tax mix thus seem adequately justified in terms of various objectives usually assigned to tax policy. This conclusion is not affected significantly when one takes economic objectives into account. Closer consideration of these objectives suggests, however, that some further refinements in the structure of wealth taxes might be desirable in most countries (e.g., higher estate taxes on large estates, and differential taxes on land and buildings) although other common features (e.g., favourable treatment of direct descendants) seem poorly conceived.

There are, however, two main constraints on wealth taxes in most countries: their possible effects on capital flows and the difficulty of satisfactorily assessing wealth (or even real property). The first of these constraints counsels caution in pushing wealth taxes to the high levels that might seem indicated by such goals as reducing the concentration of wealth -- though probably not as much caution as most countries have shown. The second constraint suggests that restraint in designing elaborate tax structures may be the better part of wisdom. This advise seems particularly warranted with regard to real property taxes, which are usually mass taxes and often in part locally administered. Since the main taxes on personal wealth -- the net wealth tax and death taxes -- are usually (and quite properly) confined to a relatively small wealthy minority of taxpayers, however, countries may be more daring in their design, though probably not to the lengths proposed by some scholars. [61]

The most severe deficiency in the wealth tax system of most countries probably lies in the inadequate structure of their death taxes, where higher rates on larger estates and less favourable treatment of bequests to close relatives seem called for if the tax is to achieve its alleged ends. However, change in this direction seems unlikely not only for the obvious political reasons but also because few issues arouse emotion so out of proportion to their importance as death taxes, perhaps because of the conjunction of two events which few people anticipate with pleasure. [62] Despite this curious general dislike of death taxes, however, there can be little question that of all taxes on wealth, death taxes are the most abused, least understood, and -- from an economic as from a social point of view -- least well-utilized in all countries.

When substantial revenue is produced through wealth taxation, it is invariably through relatively low-rate gross taxes on real property; when wealth taxation effectively supplements the income tax as a way of allocating taxation "fairly" (in accordance with ability to pay), it is generally the net wealth tax that does the job; but the only tax which even aims at the "higher" social objectives of achieving some degree of equality of opportunity and reducing the concentration of material wealth in most countries is the death tax. Despite its inevitable deficiencies in administration, its (largely) unnecessary deficiencies in structure, its invariably small revenue yield, and its allegedly pernicious economic effects, death taxation thus remains a subject worthy of much more study and attention than it appears to have received in most countries, certainly in most developing countries.

To take a specific example, even Colombia, with its enviable status in Latin America as the country with the best-developed net wealth tax and a relatively well-functioning real property tax (and valorization) system, appears to have neglected unduly this crucial component of a good tax system. As one review noted, it is somewhat curious that even the voluminous Musgrave report (and accompanying staff papers) failed to discuss this subject. [63] The 1974 reform, which exempted all transfers to spouses or parents and children from the inheritance tax, and made the tax on these transfers -- indeed on all gratuitous transfers -- depend on the amount of other "irregular" income, is also difficult to understand from this perspective.

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61. Notably by Vickrey and Meade: see note 15 above. Tait, Chap. 11, provides some useful criticisms of the former; A.R. Prest, in forthcoming review articles in the *Economic Journal* and *the British Tax Review* does the same for Meade.
62. The curious Canadian history certainly confirms this statement: see Bird and Bucovetsky, Chap. 3, and also Bird, "Canada's Vanishing Death Taxes", *Osgoode Hall Law Journal*, forthcoming.
63. Shoup, "Three Fiscal Reports", p. 61. Bird, *Taxation and Development*, also omitted this subject. Although Milton C. Taylor et al., *Fiscal Survey of Colombia* (Baltimore: Johns Hopkins Press, 1964), Chap. 5, did treat death taxes, the discussion was cursory, and no important recommendations were made.

Lumping together death and income taxes in this way completely neglects the supposed social aims of death taxation. (Both theory [64] and practice [65] suggest that it is not enough to answer any doubts about the wisdom of, in effect, taxing gifts and inheritances as income by arguing that more revenue will be generated in this way than under some particular separate tax system. [66])

As discussed earlier, there are good social reasons for directing wealth transfer taxes more sharply at great concentrations of wealth and only one significant economic argument against doing so: whether the loss from any resulting capital outflow outweighs the social gain is in the end a political question. Indeed, in the end, the appropriate design of wealth taxes (like all taxes, but more so) is a political question: is it likely to be any easier to reduce the concentration of wealth indirectly through taxation than directly? Colombia's long experience with land reform, for example, suggests that the answer is "No", [67] though there is no doubt that wealth could equitably bear a much heavier tax load if it were decided that it should do so. Within limits, the problem, as so often is the case in tax reform, is not so much administrative or economic -- though the former has some affect on the structure of what is possible and the latter on the level -- but political. Unfortunately, the economist as such has little to contribute to the resolution of this problem.

64. See Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938), p. 144, and G. Jantscher in *Proceedings of 20th Tax Conference* (Toronto: Canadian Tax Foundation, 1967), p. 417.
65. Again, reference is made to Canadian experience: see note 62.
66. Malcolm Gillis and Charles E. McLure Jr., "The Colombian Tax Reform of 1974", Vol. III of World Bank, "Economic Position and Prospects of Colombia 1975" (mimeo), p. 11-68, in effect say that the Colombian system would be fine if capital gains were taxed constructively at death. (Canada did just this -- as it turned out, at the price of giving up death taxes.) The point here is that this is not enough to achieve the goals usually assigned to wealth taxes.
67. See, especially, Albert O. Hirschman, *Journeys Toward Progress* (New York: Twentieth Century Fund, 1963), pp. 121-177; also Bird, *Taxing Agricultural Land*, pp. 259-267.

# U.S.A.: Constructive Dividend

The Internal Revenue Bulletin No. 1978-10 of March 6, 1978 published Revenue Ruling 78-83. The concept of constructive dividend is clarified in a case of diversion of income between foreign subsidiaries.

The income a foreign subsidiary corporation diverted to its sister foreign subsidiary corporation in excess of reasonable compensation for the sister corporation's services and expenses on its behalf will be treated as a constructive dividend to their domestic common parent corporation to the extent of the first subsidiary's earnings and profits and as a capital contribution by the the parent to the sister subsidiary.

The text of the ruling is as follows:

Advice has been requested whether income of X corporation diverted to Y corporation will be treated as a distribution taxable as a dividend to P corporation to the extent of the earnings and profits of X and a capital contribution by P to Y, under the circumstances described below.

The taxpayer, P, a domestic corporation, owned all of the stock of X, a foreign corporation incorporated in country M. X produces and exports fiber for sale on the world market, but due to monetary restrictions, X has had difficulty in securing dollars needed to pay refunds to foreign customers and to pay travel expenses of its employees outside country M. P., therefore, formed Y, a wholly owned foreign corporation incorporated in country T to act on behalf of X to receive part of the sales price charged by X. Thereafter, some of these dollars accumulated by Y were used to pay the above-mentioned refunds and expenses, as well as certain promotion expenses in connection with the fiber sales. P provided incidental services for X in connection with these disbursements, but performed no services in connection with the fiber sales. The funds diverted from X to Y were in excess of the amounts necessary to provide Y with reasonable compensation for its services to X and to reimburse Y for the expenses it incurred on behalf of X.

Section 301(a) of the Internal Revenue Code of 1954 provides that except as otherwise provided in subchapter C of the Code, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

Section 301(c) of the Code provides, in part, that in the case of a distribution to which subsection (a) applies, that portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

Section 1.301-1 (c) of the Income Tax Regulations provides that section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such. A distribuiton to a shareholder in his capacity as such, need not be formally declared and paid but may take the form of a constructive dividend.

Section 482 of the Code provides authority to distribute, apportion or allocate gross income, deductions, and credits among related oganizations, trades, or businesses if it is necessary in order to clearly reflect the income of such entities or to prevent the evasion of taxes.

Section 482 of the Code applies to transactions between brother-sister corporations involving hte performance of services by one for the benefit of the other that result in significant shifting of income.

Where an allocation is made under section 482 as a result of an excessive charge for services rendered between brother-sister corporations, the amount of the allocation will be treated as a distribution to the controlling shareholder with respect to the stock of the entity whose income is increased and as a capital contribution by the controlling shareholder to the other entity involved in the transaction. See Rev. Rul. 69-630, 1969-2 C.B. 112, relating to a bargain sale between brother-sister controlled corporations.

A constructive dividend is paid when a corporation diverts property, directly or indirectly, to the use of a shareholder without expectation of repayment, even though no formal dividend has been declared.

**[Continued on p. 490]**

# Some International Problems relating to the Taxation of Interest

by R.V. Giddy*

One of the difficulties encountered when dealing with interest is that it is "all things to all men". To the private or corporate investor it represents a return on savings; to the banker it is part of his profits from banking [1] and to the trader or manufacturer, who sells on extended credit terms, it is closely linked to his sales. [2]

There are very few forms of income which have given rise to so many conflicting claims for exclusive or partial fiscal jurisdiction. This is partly due to the dual role of interest mentioned in the preceding paragraph, partly due to the many locations involved in any given transaction and partly due to the suspicion that some interest payments are appropriations of profits rather than payments made to earn them. In general terms, however, three different approaches, which to a certain extent overlap, have emerged. The first is that tax on interest should go to the country in which the *debtor is resident;* the second is that it should go to the country in which the *creditor is resident* and the third is that it should go to the country in which the *source of interest is situated.* From a practical and legal point of view the approach which has given rise to most problems has probably been the last one. During the period before income tax became a federal responsibility in Australia, several cases reached the courts which required decisions on the Australian state in which the interest arose. Various arguments were considered, however, and the position was exhaustively considered in two later non-Australian cases: (i) a South African Court of Appeal case — *CIR v. Lever Brothers & Unilever Ltd. (1946) 14 S.A.T.C. 1;* and (ii) a New Zealand Court of Appeal case — *Commissioner of Inland Revenue (N.Z.) v. N.V. Philips' Gloeilampenfabrieken, 10 ATD 435.* The respective Courts of Appeal in these cases rejected certain tests, e.g., the fund from which the interest came, the actual locality of the debt itself and the right of the creditor to recover the debt. The South African Court of Appeal eventually came down in favour of locating the source of interest in the place where the credit for the loan was made available, although one dissenting judge (Schreiner J.A.) maintained that in the case of income from property there cannot be any question of activities being the source of the income. Interest, in his opinion, was the fruit of the money and came from where the money was, irrespective of the place where the contract was made or the interest payable. The New Zealand Court of Appeal also favoured "the provision of credit" approach. Another argument which has surfaced from time to time is that it is the currency in which the debt is stated which determines the source of interest although in these days of Euro-currencies this is no longer being seriously advanced. Another test suggested is that where the debt in question is secured by a mortgage, it is the physical situation of the property mortgaged which determines the source of the interest; alternatively, that it is the locality of the mortgage debt itself which determines the situation. Some of these arguments were partly influenced by early United Kingdom probate and stamp duty cases relating to the situation of debts and in particular the so-called "Speciality Debts" of *English* (not Scottish) law. It is because of casuistical arguments like these and the ease with which loans can, in the modern world of international finance, be shifted from one country to another by a phone call that writers, such as Arthur Dale [3], advocate a more practical approach by looking at the residence of either the lender or the borrower. Arguments in favour of either are readily available; however, the cynic might be forgiven if he came to the conclusion that countries which are net borrowers consider that the tax should either go to the country in which the borrower is resident or where the interest arises (very often the same thing), and that the countries which are net lenders consider the tax should go to them. In many cases tax is charged by countries on both a residence basis, as far as residents are concerned, and a source basis as far as non-residents are concerned. Because of the different and often strongly held views on the matter, the OEEC fiscal committee felt that the reservation of exclusive rights in respect of interest to one country would not obtain general support and proposed a compromise solution, i.e, that interest should be taxed in the country of residence of the recipient but that the payer country should be permitted to charge tax within certain limits. This approach has been adopted in the model OECD Convention which has replaced the earlier OEEC draft.

As stated, notwithstanding the multiplicity of possible and sometimes conflicting tests which have been used to determine the source of interest, several countries still continue to tax residents and/or non-residents on interest

* Commissioner of Inland Revenue, Hong Kong.
This paper represents his personal views and not necessarily those of the Hong Kong Government.
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1. Following the decision in *Hughes v. Bank of New Zealand Ltd., 21 T.C. 472,* the exemption available to non-residents in respect of interest on certain United Kingdom Government stocks was withdrawn where the interest formed part of the profits from a trade or business carried on in the United Kingdom.
2. See *Studebaker Corporation of Australia Ltd. v. C.O.T., 29 CLR 225,* where it was held that, in the case of interest on the unpaid balance due on cars bought by an Australian company in America and imported into Australia, the interest was part and parcel of one business transaction and that it arose from business transacted and wholly carried out in America and was not therefore interest arising from a source in New South Wales; also see Para. 142 of *Silke on South African Income Tax* — 8th Edition.
3. "Tax Harmonization in Europe", page 67.

having its source in that country; however, in view of the ease with which some of these tests can be manipulated, the charge has almost invariably been reinforced by provisions which deem certain classes of interest to arise in that country. Usually, this is done by relating the source of the interest to the place where the funds are used (e.g., Malaysia section 15; Singapore section 12(6); South Africa section 64A; Australia section 128B; Kenya; Zambia and Fiji).

In recent years, the Andean Pact Model Convention [4] came out strongly in favour of giving the country of source the right to tax the interest. It then goes on to provide, subject to rebuttal, a presumption that the loan has been used in the country from which the interest payment has been made. One cannot but help wonder whether the effort at what is in effect double deeming, i.e., placing the emphasis on the place where the interest is payable, will serve its purpose in the light of modern international banking practice and the emergence of a sophisticated network of Euro-currency financing.

One of the arguments frequently voiced against the principle of granting the country of source (or the residence of the borrower which is often the same thing) the tax, is that it is modern international banking practice for the borrower to carry the burden of any withholding tax so that, whatever the fiscal yield, the cost of borrowing is increased or borrowing is made more difficult, very often in developing countries where finance is in any case particularly difficult to come by. The argument in favour of taxing on a source basis is that large payments of interest to foreigners may be charged against domestic profits and erode the yield of tax from this source without a corresponding charge on the recipient of the interest. There is also the complication which arises in many tax systems where the payment of interest and the payment of dividends receive different tax treatment. In these cases the preferential treatment of interest can distort decisions on the raising of capital.

So much then for interest *qua* interest. However, as suggested in the opening paragraph of this article problems become aggravated where the interest forms part of the profit of banks and similar institutions. The two court decisions cited earlier did not deal with banking profits and it can be argued that a bank's profits arise in the country in which it carries on its business. This inevitably has the result that both the country in which the interest is claimed to have arisen and the country in which the profits are said to have arisen claim the prior right to tax the interest and the position can only be resolved by double taxation agreements although even here problems are encountered [5]. Indeed, it is not too difficult to envisage cases where treble taxation can result. For example, a bank resident in Country A paying tax to Country A on its global profits has a branch in Country B which pays tax on its branch profits to Country B. This branch buys interest-bearing bonds of Country C and suffers the withholding tax imposed by Country C. This brings one face to face with a further powerful complaint of the banking sector against withholding taxes imposed on non-residents and this is that it inevitably takes no account of the expenses incurred by the recipient of the interest in producing that interest and that tax is therefore indiscriminately imposed on the gross amount. It is small wonder that, notwithstanding the extensive network of double taxation agreements and unilateral relief from taxation, that creature of need, the Euro-currency market, has flourished to such an extent in the 1960s and 1970s. It also explains the emergency of some little known tropical paradise from relative obscurity.

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4. See "The Treatment of Investment Income under the Andean Pact Model Convention" by François Gendre — Bulletin for International Fiscal Documentation No. 2 of 1975, and also the paper for the CIAT Conference 1977 by Dr. Ramón Valdés Costa in Bulletin No. 1 of 1978, p. 12.
5. See British Tax Review, No. 6/1977 (page 331), where Harvey McGregor discusses the Joint Statement issued by the United Kingdom and the United States Revenue Authorities on the overlap of Articles III and XV of the Double Taxation Agreement.

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## UNITED STATES:

### Constructive Dividend

**[Continued from p. 488]**

Generally, in those cases involving corporations controlled by the same persons, the courts have found a constructive dividend to have been distributed to the common shareholders where one of the corporations was used as a device for siphoning off the earnings and profits. See *Helvering v. Gordon*, 87 F.2d 663 (8th Cir. 1937); *Commissioner v. Greenspun*, 156 F.2d 917 (5th Cir. 1946); *Biltmore Homes, Inc. v. Commissioner*, 288 F.2d 336 (4th Cir. 1961).

However, a constructive dividend is a diversion of the property, not of the income. Income is a characterization which tax law attributes to certain receipts of property, whereas a constructive distribution is that of property itself. Thus, where property is transferred from one affiliate to a sister corporation without adequate consideration therefor, there is a constructive distribution to the common parent whether or not the motive for the transfer was an attempt improperly to allocate income or deductions between the corporations.

However, any amount diverted to Y for disbursement on behalf of X, or as reasonable compensation for services rendered to X, would not be considered as constructive dividend income to P.

Accordingly, the income of X diverted to Y in excess of the disbursements on behalf of X and reasonable compensation for services of Y will be treated as a distribution taxable as a dividend to P to the extent of the earnings and profits of X, and a capital contribution by P to Y.

# THAILAND:

# Taxation of Corporate Foreign Investment Income

by M.P. Dominic*

*Thailand welcomes foreign investment and grants a number of fiscal incentives to attract it. Preference is given to agro industries, labour intensive industries and export-oriented industries.*

*The important taxes which affect corporate foreign investment income are:*
- *juristic person income tax;*
- *tax on remittances; and*
- *petroleum income tax.*

*The tax treatment of corporate foreign investment income differs under the internal tax law and under the treaty provisions. Further, special provisions apply to certain categories of business. Only the internal tax law provisions are analysed in this article: Part A deals with the regular tax provisions, Part B with tax incentives. The special provisions relating to shipping, aircraft, insurance and extractive industries are not dealt with, nor will the petroleum income tax be discussed.*

## A. INTERNAL TAX LAW

### i) *Business income*

1. Resident companies (i.e. companies incorporated in Thailand) are taxed on the net profits arising from or in consequence of the business carried on in Thailand or outside Thailand. Non-resident companies are taxed on net profits arising from or in consequence of a business carried on in Thailand. A non-resident company having in Thailand an employee, representative or a go-between to carry on business and thereby deriving income from Thailand is also deemed to carry on its business in Thailand. Such an employee, representative or go-between, whether he is a natural or legal person, is deemed to be the company's agent.

2. Business income in Thailand will be taxed if the business which results in profits is carried on in Thailand. Hence, the place of payment is immaterial.

3. Direct exporters to Thailand will not be subject to tax in Thailand on their export income. However, if the foreign exporter has an indenting agent in Thailand who collects orders for the principal overseas, the foreign exporter will be deemed to carry on a business in Thailand and hence will be taxed on the export income. Where it is not possible to determine the export profits of the foreign exporter, the export profits will be determined at the rate of 2 percent of the gross sales in Thailand. The indenting agent is liable to file the tax return and pay the tax on behalf of the foreign company. The same applies if the foreign exporter has a representative or a go-between and thereby derives export income in Thailand.

4. Exports made from Thailand by any person to or under the instruction of his head office, branch, principal, agent, employer are treated as sales made in Thailand and hence the export profits based on the market value of the exported goods at the date of export will be taxed in Thailand. However, this provision will not apply in the following instances:
i) goods sent exclusively as samples;
ii) goods sent exclusively for research purposes;
iii) goods for transshipment;
iv) return of imported goods to the foreign exporter within one year from the date of import;
v) return of exported goods to the exporter in Thailand within one year of the date of export.

5. All non-capital expenditures which are exclusively expended for the purpose of the business in Thailand may be deducted unless they are specifically excluded by the Revenue Code. Where the net business profits cannot be ascertained, the business profits may be estimated by the assessment officer at the rate of 2 percent of the gross receipts or gross sales without deduction of expenses, whichever amount is greater. In general, the straight line depreciation method is employed. However, the taxpayer may choose any other method of depreciation. The depreciation rates may not exceed the rates specified under the Revenue Code. For plant and machinery the rate is, in general, 20 percent. Losses may be carried forward for a period of five years. No provision is made for carry back of losses.

6. Listed companies (i.e. companies listed on the Thailand Securities Exchange) are subject to juristic person income tax at the rate of 30 percent. Non-listed companies are subject to juristic person income tax at the rate of 35 percent. No distinction is made between resident and non-resident companies.

7. Closely held companies are subject to personal income tax and not to juristic person income tax. A company is closely held if any person holds shares or capital amounting to more than 50 percent of the entire capital of a juristic company. A company in which a non-closely held company holds more than 50 percent of the shares or capital is not treated as a closely held company.

8. Where a company remits its business income or retains its business income abroad the remittance will be subject to tax at the rate of 25 percent.

### ii) *Dividends*

A resident company is subject to juristic person income tax on domestic dividends and foreign dividends. A non-resident company, whether carrying on business in Thailand or not, is subject to tax on domestic dividends only. Stock dividends, increased amount of capital holdings arising from the capitalization of profits or reserves, gains exceeding the cost of investment which arise from liquidation, amalgamation or acquisition and payments received as a result of reduction of capital are subjec to juristic person income tax.
Dividends received by non-resident companies which do not carry on business in Thailand are subject to withholding tax.

### iii) *Interest*

A resident company is taxed on world-wide interest income. A non-resident company, whether carrying on business in Thailand or not, is subject to tax on domestic source interest. The difference between the redemption value and the selling price of a bill or certificate of indebtedness issued by a finance company and sold for the first time at a price below its redemption value is treated as interest income. Interest paid to a non-resident company which does not carry on a business in Thailand is subject to withholding tax.

### iv) *Royalties*

A resident company is subject to juristic person tax on its world-wide royalties. A non-resident company, whether carrying on business in Thailand or not, is subject to tax only on domestic source royalties. Tax is withheld from royalties paid to non-resident companies not carrying on a business in Thailand.

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* Attorney at law, Sri Lanka, Drs. in de rechtswetenschappen (Netherlands). Formerly visiting lecturer at the University of Sri Lanka (Colombo) and tutor at Sri Lanka Law College.

 

**B. INCENTIVES**

From the general provisions discussed under Part A, a number of departures are made by the Investment Promotion Law in order to encourage investments which are considered important and useful to the social and economic development of Thailand as may be promoted by the Board of Investment. The incentives relating to juristic person income tax granted under the Investment Promotion Law are as follows:

*1) Tax holiday*

Profits from promoted investment will be exempted for a period of 3-8 years beginning from the date the profits are first derived from such activity. This exemption may be extended, at the Board's discretion, to income from the sale of by-products and semifinished products. The tax exemption will be granted only if the capital exporting country provides tax exemption or tax sparing credit in respect of the exempted profits in Thailand.

The tax holiday does not apply to the tax on remittances.

*2) Carry forward of losses*

Losses incurred during the tax holiday period may be carried forward and set off for a period of five years against the net profits accruing after the tax holiday period. A choice is given either to set off the losses from the net profits of any one year or several years during the five-year period.

*3) Partial tax holiday*

For a further period of five years, 50 percent of the juristic person income tax will be reduced if the investment is located in an investment promotion area.

*4) Export allowance*

Five percent of the increased income attributable to exports of products or commodities produced or assembled by the promoted investment (exclusive of overseas insurance and freight charges), over the previous years, is exempted.

*5) Investment allowance*

A 25 percent investment allowance is given in respect of the cost of construction of infrastructures used in a promoted business. The allowance may be claimed against the income in any one year or for a period of several years within 10 years from the date on which income is first derived from the investment. The investment allowance is in addition to the normal depreciation.

*6) Double deduction* is allowed for expenses incurred on water, transport and electricity by a promoted investment in an investment promotion area.

*7) Dividends* paid by a promoted investment are tax exempt.

*8) Royalties* paid by a promoted investment are tax exempt for a period of five years beginning from the date income is first derived from the promoted investment if the licensing contract is approved by the Board of Investment.

*9) Special incentives* are also provided for companies listed on the Securities Exchange of Thailand and for companies engaged in petroleum survey and exploration in Thailand.

# Recent Tax Changes in Thailand

Announcements 8-10 were proclaimed on 7 November 1977 and were published in the Government Gazette on the following day.

**Announcement 8**

Effective 9 November 1977, police officers are prohibited from investigating tax cases under the Revenue Code unless criminal cases are involved or at the request of a Revenue Officer. All pending police investigations must be closed within six months from 9 November 1977. After the expiry of the six-month period cases must be transferred to Revenue Officers who must complete the assessments within two years of the date of receiving them from the police. Earlier, police officers were allowed to investigate tax cases and "it was not uncommon for small business to be harassed by police investigations of alleged tax evasion, and, whether or not the police had justification, life could be made very difficult for some people. There is a law on the books, for instance, which specifies a fine of 500 baht per missing or incorrect invoice. If enough invoices can be shown to have been 'lost', the fine can be extremely high, and what was more, there was no time limit to any investigation". [1]

Announcement 8 has also specified the period within which assessment must be completed. All pending cases must be completed within two years from 9 November 1977. No new assessment may take longer than two years. If assessment cannot be completed within two years, investigations must be closed unless the period is extended by the Minister of Finance on reasonable grounds. The extended period may not exceed one year. The Director General of the Revenue Department is required to report every six months to the Minister of Finance on the number of pending cases and their positions.

**Announcement 9**

Amnesty was granted for payment of fines and surcharges for taxpayers in arrears, if they paid their tax arrears before 31 January 1978, if summons had not already been issued on them or they were subject to investigation. This amnesty was extended even to taxpayers who had been summonsed or were subject to investigation if they had not yet received assessments. If the taxpayers received assessments before 9 November and paid their taxes before 31 January 1978, they need pay only reduced fines and surcharges varying according to the circumstances of the case.

It may be noted that under the Revenue Code heavy fines and surcharges are imposed. The fines are, in general, twice the tax payable. In addition, there is a surcharge of 1 percent per month imposed for every month in default on the tax arrears and fines.

If a person with gains from sale of land which was not sold in the course of business has improperly included such gains in his declaration he may claim income tax exemption if revised income tax return forms are submitted before 31 January 1978.

**Announcement 10**

The provisions of this announcement include the following:

— The juristic person income tax (i.e. company tax) rates went from 20, 25 or 30 percent (depending on the amount of profits) to a flat rate of 35 percent. However, a company listed on the Securities Exchange of Thailand will be taxed only at 30 percent.

— Income tax on interest earned from a credit financier is reduced to 10 percent (i.e. the same rate imposed on interest earned from finance companies).

— Interest earned from bank deposits (other than interest from savings deposits) will be taxed at the rate of 10 percent. Earlier, such interest was not subject to tax.

1. New Government Taxation — Its Implications for Business Investor, February 1978, 49 at 50.

— Dividends received from a registered company or mutual fund are exempt up to 400,000 baht and dividends received from other companies up to 200,000 baht.

— Deduction is allowed in respect of income tax on writers and composers.

— Husbands and wives may file separate income tax returns.

— Business men engaged in hire-purchase, sale of goods and hire of work must issue receipts for 100 baht or more.

— Government and state enterprises and organisations must deduct 2.2 percent business tax at source from their payments.

— Stamp duties on bills of exchange, promissory notes, bills of lading, cheques and travellers cheques were increased from 25 stang to 1 baht.

— Stamp duties for letters of credit were increased from 1, 3 and 5 baht to 10, 12 and 20 baht.

— Stamp duties on memoranda and articles of association were increased from 50 to 100 baht.

— Stamp duties on new articles of association or amendments were increased from 10 to 20 baht.

— Stamp duties on partnership agreements were increased from 2 to 20 baht and 10 to 50 baht.

— Capital gains arising from trading in securities between May 1978 and 31 December 1979 will be subject to 10 percent tax if the securities are traded within six months of their acquisition. The Securities Exchange of Thailand and the brokers are responsible for the collection of the tax on capital gains. Income from the sale of securities on the Securities Exchange of Thailand is exempt if they were acquired at least six months before their sale. From January 1980, capital gains will be subject to individual income tax or juristic person income tax like any other income. [2]

2. TNS II-34, 1978.

**LAST MINUTE CONFERENCE NEWS**

*Marchmont Conferences:* The International Tax Planning Conference, Nassau, The Bahamas, January 10-12, 1979 (English).

For further information please write to: Marchmont Conferences, 24 Hanover Square, London WIR 9 RD (U.K.).

# tax note

## Recent Changes in Papua New Guinea*

The Papua New Guinean Finance Minister Mr. Barry Holloway has announced four incentives in order to stimulate investment. In the words of the Minister, they are "a set of precision tools rather than a blunt instrument". The four incentives are:

— 50 percent exemption of increased export profits from company tax. The exemption does not apply to exports of primary produce and income derived from exports at the existing level.

— Contribution by the Government to the cost of feasibility studies on approved projects. The contribution will be up to 50 percent of the cost but not exceeding US$ 136,600. When the project is established as a result of the feasibility study, shares to the value of the contribution must be issued to the Government.

— Long term credit to new manufacturing or processing industries which are making losses in their first four years of operation. The credit will not exceed 15 percent of the total investment.

— Credit to 100 percent Papua New Guinean investments by the Development Bank if they lack normal commercial security. In addition, reduced rates of interest and better payment terms will be provided.

Further, the Government has made a number of changes in the tariff structure. In general, the tariffs on non-essential items have been increased and the resulting increase in the revenue is estimated to be $ 1.2 million. The Minister has stated: "I think it is quite reasonable and in line with our distributional objectives to ask consumers of non-essential items to bear this modest additional burden". Examples of the increase are:

— Passenger cars, motocycles of over 125(c), cameras, radios, tape recorders, stereo sets, perfumes, unexposed films — 50 percent (earlier rate 5 percent).

— Electrical applicances — 30 percent (earlier 10 percent)

— Watches — 40 percent (earlier 10 percent).

The Government is also planning to close the loopholes relating to the withholding tax at 15 percent on company dividends.

* Note submitted by M.P. Dominic.

# SRI LANKA:
# Inland Revenue (Amendment) Law, No. 30 of 1978

By M.P. DOMINIC

The Budget proposals have been enacted into law by the Inland Revenue (Amendment) Law, No. 30 of 1978, but in consequence of promises made during the Budget discussions the following provisions are made:

### 1) Tax exemptions

A company incorporated on or after 15 November 1977 and approved by the Minister of Finance will be exempt up to 31 March 1983 on its profits from the following undertakings:

a) Offshore or deepsea fishing;
b) Offshore or deepsea fishing and the processing of the product of such activity;
c) Animal husbandry;
d) Cultivation of non-traditional crops;
e) Cultivation of non-traditional crops and the processing of the product of such cultivation.

The company must be engaged only in one or more of the undertakings specified above. The exemption will be denied if the undertaking was in existence prior to 15 November 1977 or formed by the splitting up or reconstruction of such an undertaking. No exemption is given for dividends paid from the exempt profits.

A limited exemption equivalent to 100,000 Rs. per annum is given up to 31 March 1983 to undertakings engaged in the production or manufacture of goods or commodities (other than milling of paddy) if the undertaking commenced on or after 15 September 1977. In order to be eligible for the exemption, the following additional conditions must be satisfied:

a) the undertaking must be approved by the Minister of Finance;
b) the undertaking must not be formed by the splitting up, reconstruction or acquisition of a business previously in existence;
c) the place of production or manufacture must be outside the Municipal Council limits;
d) the aggregate cost of fixed assets and value of other assets (excluding retained profits) should not be more than 500,000 Rs. throughout the year.

No exemption is given to dividends declared out of the exempt profits.

Tax exemption varying according to the square footage of houses or flats constructed and sold is available to undertakings engaged in the construction and sale of houses or flats if the following conditions are satisfied:

a) construction must have commenced on or after 1 January 1977, and
b) the undertaking must have been approved by the Minister of National Housing.

The exemption varies as follows:
floor area not exceeding 500 sq.ft. — 100 percent;
floor area between 500 and 1,250 sq.ft. — 75 percent
floor area between 1,250 and 2,000 sq.ft. — 50 percent.

The exemption will not apply to profits from sale of land appurtenant to house or flat in excess of the following limits:

| Nature of unit | Within M.C or U.C Area | Outside M.C. or U.C. Area |
|---|---|---|
| House | 10 Perches | 20 Perches |
| Flat | 5 Perches | 10 Perches |

Dividends paid out of exempt profits are also exempt.

Exemption is given up to 31 March 1983 for profits from milling of paddy if the following conditions are satisfied:

a) the undertaking for the milling of paddy must have commenced on or after 15 November 1977;
b) the undertaking must have been approved by the Minister;
c) the undertaking must not have been formed by the splitting up, reconstruction or acquisition of an undertaking in existence prior to 15 November 1977;
d) a certificate confirming compliance with conditions of quantity and quality of rice supplied must be produced.

Dividends declared out of exempt profits are not exempt from tax.

### 2) Family and children's allowances

The family allowances and children's allowance have been increased as follows:

Family consisting of husband and wife without children or dependent relative — 500 Rs.

Children's allowance
a) one child or dependent relative — 1000 Rs.
b) two children or dependent relatives or one child and one dependent relative — 2000 Rs.
c) three or more children or dependent relatives on three or more children and dependent relatives — 3000 Rs.

### 3) Income tax rate schedules

The new income tax rate schedule applicable to resident individuals is as follows:

| | |
|---|---|
| On the first 1,800 Rs. of the taxable income | 7.5 percent |
| On the next 1,800 Rs. of the taxable income | 10 percent |
| On the next 3,600 Rs. of the taxable income | 12.5 percent |
| On the next 3,600 Rs. of the taxable income | 15 percent |
| On the next 3,600 Rs. of the taxable income | 20 percent |
| On the next 3,600 Rs. of the taxable income | 25 percent |
| On the next 3,600 Rs. of the taxable income | 30 percent |
| On the next 3,600 Rs. of the taxable income | 35 percent |
| On the next 4,800 Rs. of the taxable income | 40 percent |
| On the next 7,200 Rs. of the taxable income | 45 percent |
| On the next 7,200 Rs. of the taxable income | 50 percent |
| On the next 7,200 Rs. of the taxable income | 55 percent |
| On the next 7,200 Rs. of the taxable income | 60 percent |
| On the next 7,200 Rs. of the taxable income | 65 percent |
| On the balance of the taxable income | 70 percent |

The new income tax rate schedule applicable to non-resident individuals is as follows:

| | |
|---|---|
| On the first 15,000 Rs. of the taxable income | 15 percent |
| On the next 6,000 Rs. of the taxable income | 20 percent |
| On the next 6,000 Rs. of the taxable income | 25 percent |
| On the next 6,000 Rs. of the taxable income | 30 percent |
| On the next 6,000 Rs. of the taxable income | 40 percent |
| On the next 6,000 Rs. of the taxable income | 50 percent |
| On the next 6,000 Rs. of the taxable income | 60 percent |
| On the balance of the taxable income | 70 percent |

## 4) Depreciation allowances

After the Amendment Law the position relating to depreciation allowances is as follows:

| *Nature of the asset* | *Person entitled* | *Rate* |
|---|---|---|
| a) *Trade, business or profession (including agricultural and industrial undertakings)* | | |
| — Plant, machinery, fixtures | Owner-user (including purchaser) | 100 percent in the year of acquisition |
| — Motor-cycle or bicycle used by a non-executive employee | Employee carrying on the trade, etc. | Reasonable amount |
| — Dwelling houses for non-executive employees | Employer who incurred the construction expenditure | 100 percent in the year of construction |
| — Industrial buildings (agriculture, industry and approved project including hotels) | Persons who incurred the construction expenditure | 50 percent in the year of construction |
| b) *Hotels* | | |
| — Plant, machinery, fixtures, furniture, utensils, articles or buildings of undertakings approved under Sec. 6(i)(v) and (vi) of the Inland Revenue Act | Owner-user (including purchaser) | 100 percent in the year of acquisition |
| — Plant, machinery, fixtures, furniture, utensils, articles or buildings or existing hotels approved under Sec. 10(i)(m) of the Inland Revenue Act | Owner-user (including purchaser) | 100 percent in the year of acquisition |
| c) *Deepsea or offshore fishing* | | |
| — Implements or equipment | Owner-user (including purchaser) | 100 percent in the year of acquisition |
| d) *Others* | | |
| — Other plant, machinery, fixtures, utensils, implements or articles employed in producing income. | Person who renewed | 100 percent of the renewed expenditure in the year of renewal |

## 5) Investment Promotion Zone

*Capital gains*

Capital gains arising from the transfer of shares in a company established in the Investment Promotion Zone, which has entered into an investment agreement with Greater Colombo Economic Commission, are exempt from income tax. The same will apply even if such an enterprise is established outside the zone if it is licensed by the Greater Colombo Economic Commission.

*Emoluments of non-citizens employed in Sri Lanka*

The emoluments and any income not arising in Sri Lanka of any scientist, technician, expert or adviser who is not a citizen of Sri Lanka and who is brought to and employed in Sri Lanka by an enterprise in the Investment Promotion Zone which has entered into an investment agreement with the Greater Colombo Economic Commission are exempt from income tax. The same will apply if such an enterprise is established outside the zone if it is licensed by the Greater Colombo Economic Commission.

*Dividends*

Dividends paid by a company in the Investment Promotion Zone which has entered into an agreement with the Greater Colombo Economic Commission are exempt from income tax. The exemption is limited to the tax holiday provided to the company and one additional year if the shareholder is a resident. For non-residents, no time limit is imposed. The same exemption is granted if such an enterprise is established outside the zone if it is licensed by the Greater Colombo Economic Commission.

*Interest*

Interest on foreign currency deposits by non-residents in approved commercial banks is exempt from income tax. Foreign currency deposits are also exempt from wealth tax.

 

IFA INTERNATIONAL FISCAL ASSOCIATION NEWS

# Journée d'étude 19 mai 1978: groupements français et belgo-luxembourgeois

## Les conventions franco-luxembourgeoise et franco-belge en vue d'éviter les doubles impositions répondent-elles aux nécessités actuelles?

Voir Observations de la section luxembourgeoise Bulletin no. 9/1978 p. 467.

English Summaries follow on p. 511.

## Deuxième partie

**Observations du rapporteur du groupement français de l'Association Internationale de Droit Fiscal, Me J.C. Goldsmith,* concernant certain points des conventions franco-belge et franco-luxembourgeoise qui font ou risquent de faire difficulté**

### Préambule

La convention franco-belge date du 10 mars 1964 et a fait l'objet d'un avenant du 15 février 1971 applicable pour la première fois aux dividendes mis en paiement à partir du 1er janvier 1970.

Pour sa part la convention franco-luxembourgeoise remonte au 1er avril 1958; mais elle a été profondément modifiée par un avenant en date du 8 septembre 1970.

C'est dire que ces conventions ne sont qu'imparfaitement inspirées de la convention modèle de l'O.C.D.E. de 1963. En fait, elles s'en écartent sensiblement malgré les modifications qui y ont été apportées.

Les doubles impositions auxquelles elles peuvent conduire seraient, dans leur ensemble, considérablement sinon totalement réduites par l'adoption des normes posées par l'O.C.D.E. dans la dernière convention modèle proposée par cet organisme en 1977.

Cela dit, il est évidemment inévitable que, dans la réalité des faits, les conventions bilatérales diffèrent du modèle O.C.D.E., notamment en fonction des préoccupations propres à chacune des hautes parties contractantes. Mais il est souhaitable de ne pas perdre de vue que, dans le monde moderne, ces préoccupations doivent, dans toute la mesure du possible, céder le pas à un souci de neutralité fiscale internationale. Cela est particulièrement vrai entre Etats membres de la Communauté Economique Européenne.

Il est vrai que les projets de directives actuellement à l'étude tendent vers ce but. Mais, en attendant qu'elles voient le jour, il y a intérêt à se pencher sur les cas de double imposition qui peuvent subsister malgré les efforts déjà accomplis pour les éviter ou les résorber.

C'est l'objet du présent colloque que d'en discuter à propos des conventions franco-belge et franco-luxembourgeoise.

Notre objet n'est certes pas de tendre à une énumérative exhaustive des cas, actuels ou latents, de double imposition aux termes de ces deux conventions, mais simplement de faire ressortir quelques-uns d'entre eux et notamment ceux qui nous ont été signalés par certaines entreprises ou leurs conseils.

Dans l'ensemble le nombre de questions soulevées est limité, mais la portée de ces questions n'en pas est sans importance.

### 1. Définition de l'établissement stable

Les conventions franco-belge (Article 4) et franco-luxembourgeoise (Article 2) prévoient toutes deux, bien que dans des termes différents, que l'employé ou agent de l'entreprise qui dispose d'un stock de marchandises sur lesquelles il prélèves habituellement des produits pour livraison à la clientèle doit être, pour ce seul motif, considéré comme ayant le pouvoir de conclure des contrats au nom de l'entreprise et constitue à ce titre un établissement stable de celle-ci.

Cette norme apparaît comme étant largement dépassée. Elle est de nature à entraîner des doubles impositions, notamment au regard de la législation française qui, comme on le sait, est fondée sur la territorialité (Sous

* Avocat au Barreau de Paris. Président du Comité Fiscal de la Section du Droit des Affaires de l'International Bar Association.

réserve bien entendu des concertations entre les administrations respectives des deux Etats prévues par la Convention pour éviter les doubles charges).

Encore faut-il remarquer que l'article 4-5 de la convention franco-belge prévoit que, si plusieurs des cas énumérés dans la convention comme étant non constitutifs d'ètablissement stable peuvent être relevés simultanément à l'égard d'une même entreprise, les autorités compétentes des états contractants se concertent pour déterminer si cette situation n'est pas de nature à caractériser dans leur ensemble l'existence d'un établissement stable.

Cette disposition originale n'est pas sans être contradictoire avec les termes de l'Article 4 de la Convention qui, lui-même, ne fait que reprendre des principes bien établis en matière de convention internationale. Il y aurait avantage à ce qu'elle soit reconsidérée.

## 2. Régime des sociétés-mères

Permettons-nous une observation d'ordre très général.

Dans la plupart des Etats, les législations internes contiennent des dispositions assurant aux sociétés-mères qui remplissement certaines conditions, une transparence fiscale à peu près complète.

Les sociétés-mères ne supportent qu'une charge réduite ou nulle sur les dividendes qu'elles reçoivent de leur filiales et sont en mesure de les redistribuer presque entièrement à leurs propres actionnaires avec, s'il y a lieu, les crédits d'impôts y attachés.

En d'autres termes et à quelques réserves près, l'actionnaire direct qui encaisse le dividende d'une société et l'actionnaire indirect qui reçoit ce même dividende par l'intermédiaire d'une société-mère de la première, sont placés dans des situations comparables.

Cette équivalence de traitement suppose toutefois, en règle générale, que la société-mère et la filiale ont leur siège dans le même Etat. Elle cesse d'exister lorsque la société-mère et la filiale relèvent d'Etats différents.

Ainsi, dans les rapports franco-luxembourgeois, le transfert de l'avoir fiscal est refusé, d'une part aux sociétés

Ainsi, dans les rapports franco-luxembourgeois, le transfert de l'avoir fiscal est refusé, d'une part aux sociétés luxembourgeoises qui détiennent une participation d'au moins 25 pour cent dans le capital d'une société française (le taux de 25 pour cent est exigé au Luxembourg pour que le régime des sociétés-mères soit applicable, lorsqu'il s'agit d'une société ordinaire. Si la société a pris le statut de société holding, elle est exonérée d'impôt au Luxembourg mais ne peut bénéficier des conventions internationales), d'autre part aux sociétés et autre personnes morales belges. Du fait de cette restriction, les résidents de Belgique ou du Luxembourg qui bénéficient du dividende distribué par une société française se trouvent dans une situation très différente selon qu'ils encaissent directement ce dividende ou selon que ce dividende leur parvient à travers une société-mère belge ou luxembourgeoise.

En d'autres termes, dans de nombreux cas le passage d'une frontière demeure une cause de surcharge fiscale importante pour les dividendes.

Cette situation n'est évidemment pas satisfaisante, alors même que l'insuffisance des dispositions des conventions qui est à son origine peut être motivée par la recherche, de la part de chaque Etat contractant, soit d'une absolue garantie d'imposition dans l'autre Etat des franchises d'imposition consenties, soit d'une réciprocité, soit par toute autre préoccupation d'ordre national.

## 3. Retenue à la source sur les établissements stables

Tant la convention franco-belge (Article 17) que la convention franco-luxembourgeoise (Article 7) assujettit les établissements stables de sociétés belges en France à la retenue à la source prévue par la législation française.

La convention franco-belge dispose que cette retenue sera perçue sur une base réduite de moitié et à un taux n'excédant pas 10 pour cent. La convention franco-luxembourgeoise édicte, pour sa part, que le taux applicable de la retenue est de 5 pour cent, sans réduction de la base d'imposition.

L'Article 17-3 de la convention franco-belge prévoit, entre autres, l'application aux établissements stables en Belgique des sociétés françaises de l'impôt frappant les bénéfices distribués d'une société similaire résidente de la Belgique au taux de 10 pour cent sur la moitié de la différence entre, d'une part, le bénéfice de l'établissement stable et, d'autre part, le montant obtenu en appliquant à ce bénéfice le taux normal, en principal, de l'impôt des sociétés frappant les bénéfices distribués des sociétés résidentes de la Belgique.

Ces retenues à la source sur établissements stables font ressortir la double imposition qui s'instaure dès lors que les revenus passent la frontière.

Sur le plan national, aucun impôt tenant lieu d'impôt sur les dividendes ne saurait évidemment exister dans les relations entre un établissement et le siège social de l'entreprise. Si l'on se place sous l'angle d'une recherche de la neutralité fiscale sur le plan international, on voit tout ce que ces retenues sur établissements peuvent avoir d'insolite. Elles ne sont pas prévues par le modèle de convention de l'O.C.D.E. et y aurait lieu de les supprimer ainsi que c'est déjà le cas dans nombre de conventions.

## 4. Retenues à la source sur les dividendes de filiales

D'une façon générale, lorsque le taux de ces retenues dépasse un certain seuil, elles risquent de ne plus être imputables en totalité dans l'Etat de la résidence du bénéficiaire des dividendes.

Aussi le principe de la réduction de la retenue à 5 pour cent lorsque la Société mère possède plus de 25 pour cent du capital de la filiale, qui est retenue dans le modèle de Convention de l'O.C.D.E. est-elle bien venue (encore que, dans le commentaire qui accompagne le modèle de Convention de 1977, cette réduction soit justifiée par le soucis d' "éviter une cascade d'impositions et pour faciliter les investissements internationaux" — cf. le Commentaire de l'Article 10, § 10).

Ce principe est retenu dans un nombre croissant de conventions. Il est repris dans la convention franco-luxembourgeoise (Art. 8-2).

En revanche, la convention franco-belge (Art. 15-2-a) prévoit une retenue de 10 pour cent dans le cas où la Société bénéficiaire a la propriété exclusive d'au moins 10 pour cent du capital de la Société distributrice.

La réglementation belge applicable aux Sociétés mères de filiales étrangères ne tient plus compte des retenues à la source auxquelles les dividendes encaissés ont été assujettis dans le pays de la source.

Il s'ensuit que le montant du revenue net effectivement encaissé par l'actionnaire personne physique de la société mère belge est directement fonction de l'importance de ces retenues et varie, de façon plus ou moins sensible, selon que les dividendes perçus par cette société proviennent de filiales sises dans un pays ou dans un autre.

Le tableau comparatif ci-après, qui fait ressortir le calcul des dividendes nets reçus par les personnes physiques actionnaires de sociétés belges correspondent à des dividendes reçus par celles-ci de filiales respectivement sises aux Pays-Bas, en Suisse, en France et aux Etats-Unis illustre notre propos.

| PAYS SOURCE | PAYS-BAS | SUISSE | FRANCE | U.S.A. |
|---|---|---|---|---|
| Dividende brut | 1.000 | 1.000 | 1.000 | 1.000 |
| Retenue à la source | 50 | 350 | 100 | 150 |
| Dividende Net | 950 | 650 | 900 | 850 |
| BELGIQUE Société Mère | | | | |
| Net encaissé | 950 | 650 | 900 | 850 |
| Précompte Mobilier fictif 5 pour cent | 47,5 | 32,5 | 45 | 42,5 |
| Total | 997,5 | 682,5 | 945 | 892,5 |
| R.D.T. 95 pour cent | 947,6 | 648,3 | 897,7 | 847,8 |
| Imposable I.S. | 49,9 | 34,2 | 47,3 | 44,7 |
| I.S. 48 pour cent | 23,9 | 16,4 | 22,7 | 21,4 |
| Précompte imputable | 47,5 | 32,5 | 45 | 42,5 |
| Dégrèvement | 23,6 | 16,1 | 22,3 | 21,1 |
| Distribuable | 973,6 | 666,1 | 922,3 | 871,1 |
| Précompte de distribution | 194,7 | 133,2 | 184,4 | 174,2 |
| Actionnaire Personne Physique | | | | |
| BELGE | | | | |
| Net actionnaire | 778,9 | 532,9 | 737,9 | 696,9 |
| Base imposable | 1.421,46 | 972,51 | 1.346,59 | 1.271,81 |
| Crédit d'impôt | 642,56 | 439,61 | 608,69 | 574,91 |

## 5. Problèmes concernant les intérêts

*(a) Emprunt contracté en Belgique par l'établissement français d'une société belge*

Soit le cas de l'établissement français d'une société belge qui a contracté un emprunt auprès d'une banque belge pour ses besoins propres en France. Cet emprunt a en fait été imposé par l'Administration française qui, à l'époque des faits, avait pour pratique d'exiger qu'au moins la moitié de tout investissement étranger en France soit financé en devises. L'Administration français à perçu l'impôt à la source dans les termes de l'Article 16 de la convention, au taux réduit de 15 pour cent. L'Administration belge a contesté ce prélèvement en arguant des termes de l'article 16.4 qui stipule que les intérêts et produits des obligations et des emprunts quelconques qu'un résident de l'un des deux Etats contractants émet ou contracte dans l'autre Etat contractant pour les besoins propres de ses établissements stables situés dans ce dernier Etat sont considérés comme ayant leur source dans cet autre Etat.

Il s'ensuit que le prélèvement à la source opéré par l'Administration française au taux de 15 pour cent dans les termes de l'Article 16, Paragraphe 3 est mis en question.

La position de l'Administration belge s'appuie, par ailleurs, sur la fait que, selon l'Article 1, Paragraphe 4 de la convention, une personne morale est réputée résident de l'Etat contractant où se trouve son siège de direction effective. La conséquence en est que même si, comme dans l'espèce en cause, c'est l'établissement français de la société belge qui emprunte auprès d'un établissement de crédit belge, le prélèvement à la source opéré en France n'est pas justifié.

Ainsi la disposition complexe de l'Article 16-4 de la convention est-elle source de difficultés en ce qu'elle constitue économiquement une certaine distorsion.

*(b) Emprunt contracté par une entreprise française auprès d'une banque établie au Luxembourg (voir au même effet, le rapport luxembourgeois au présent colloque)*

Depuis la mise en vigueur de l'avenant du 8 septembre 1970 à la convention du 1er avril 1958 entre la France et le Luxembourg, l'Etat de la source est autorisé à percevoir un impôt sur les intérêts de créances.

Jusqu'à présent et pour les créances autres que les obligations négociables, seule la France use effectivement de l'autorisation d'imposer les intérêts à la source.

L'impôt prélevé en France est imputé au Luxembourg sur l'impôt sur le revenu des personnes physiques ou des collectivités, dû par le bénéficiaire, sans que l'imputation puisse excéder la franction de l'impôt luxembourgeois correspondant auxdits intérêts (Article 19, § 3a de la convention de 1958 modifiée).

Cette imputation soulève des difficultés lorsque le bénéficiaire des intérêts est une banque établie au Luxembourg qui consent des crédits à une entreprise française.

(i) L'Administration fiscale luxembourgeoise s'en tient strictement à la lettre de l'Article 19 § 3a de la convention et n'impute l'impôt français de 10 pour cent prélevé sur les intérêts que dans la limite de l'impôt luxembourgeois dû sur les mêmes intérêts.

A cet effet, elle recherche la proportion que représente le montant brut de ces recettes de la banque en intérêts et autres produits par rapport, à l'ensemble de son revenu net imposable au Luxembourg. Et elle considère que les intérêts bruts reçus de France, ne sont soumis à l'impôt luxembourgeois que dans cette proportion.

La règle ainsi fixée aboutit, le plus souvent, à ne pas permettre l'imputation intégrale de la retenue de 10 pour cent et à laisser subsister une double imposition.

Cela se comprend facilement: si l'on suppose que le taux de l'impôt luxembourgeois est de 40 pour cent, il faudrait que l'intérêt brut reçu de France et ayant supporté la retenue de 10 pour cent, figure dans le bénéfice imposable de la banque pour au moins 25 pour cent de son montant, pour que l'impôt luxembourgeois puisse absorber le montant total de la retenue.

Or un marge de 25 pour cent ne correspond pas à la réalité.

C'est précisément parce qu'il avait pris conscience de ce problème que le Comité Fiscal de l'O.C.D.E. a suggéré aux Etats contractants de supprimer le pouvoir d'imposition de l'Etat de la source lorsque les intérêts sont payés:

"(a) en liaison avec la vente à crédit d'un équipement indsutrial, commercial ou scientifique;
(b) en liaison avec la vente à crédit de marchandises livrées par une entreprise à une autre entreprise ou
(c) sur un prêt de n'importe quelle nature consenti par un établissement bancaire." (Nos. 13 à 17 des commentaires de l'Article 11; O.C.D.E. Modèle de convention 1977 pages 112 et 113).

Il serait souhaitable d'ajouter à l'article 9 de la convention franco-luxembourgeoise de 1958 modifiée, un paragraphe additionnel conforme au texte suggéré par le rapport du Comité des Affaires Fiscal de l'O.C.D.E. (No. 15 page 112).

(ii) Lorsque la retenue à la source de 10 pour cent ne peut pas être intégralement imputée sur l'impôt dû au Luxembourg, il semble que la partie non imputée devrait, à tout le moins, être considérée comme une charge venant en diminution du revenu net taxable. Il serait, en effet, anormal que l'impôt payé à lètranger et non imputé sur l'impôt du au Luxembourg, demeure néanmoins compris dans le bénéfice imposable de la banque.

Raisonnons sur l'exemple ci-après (en francs):

| | | |
|---|---|---|
| — Revenue brut total de la banque comprenant: | | 1.000 |
| — intérêts français soumis à la retenue à la source de 10 pour cent (8 francs) | 80 | |
| — autres revenue bruts | 920 | |
| — Revenue net taxable de la banque au Luxembourg | | 75 |
| — Proportion dans laquelle les intérêts français sont censés se retrouver dans revenue net taxable: $\frac{75 \times 80}{1000}$ soit | 6 | |
| — Montant de l'impôt luxembourgeois correspondant aux intérêts de source française et qui constitue le plafond de la déduction autorisée par l'Article 19 § 3 : 6 x 40 pour cent = | | 2,40 |

Une première attitude consiste à liquider ainsi l'impôt des collectivités au Luxembourg:

| | |
|---|---|
| — Impôt dû : 75 c 40 pour cent = | 30,00 |
| — Maximum à déduire au titre de la retenue de 10 pour cent ayant frappé les intérêts de source française: | 2,40 |
| Impôt net dû: | 27,60 |

Il semble qu'un tel raisonnement serait incomplet.

La retenue de 8 prélevée en France n'a pas été encaissée par la banque. Dans la mesure où elle ne constitue pas un crédit et tombe en non-valeur, il paraît logique de la déduire du revenu net taxable.

La liquidation devrait donc être complétée ainsi:

| | |
|---|---|
| — retenue à exclure du revenu net taxable: 8 — 2,40 = | 5,60 |
| — revenue net taxable: 75 — 5,60 = | 69.40 |
| — impôt des collectivités: à 40 pour cent sur 69,40 = | 27,76 |
| — retenue française imputable: | 2,40 |
| Impôt net dû au Luxembourg: (au lieu de 27,30 francs) | 25,36 |

Si l'on refusait de compléter le calcul de la manière qui vient d'être indiquée, le système dudit crédit limité au montant de l'impôt luxembourgeois pourrait être moins favorable que celui consistant à n'accorder aucun crédit au titre des impôts étrangers et à considérer ceux-ci simplement comme des charges.

Soit, dans notre example:
Revenue net taxable (après déduction de la retenue acquittée en France): 75 — 8 = 67

Impôt des collectivités:
67 x 40 pour cent = 26,8 (au lieu de 27,30 dans la première méthode).

### 6. Durée des chantiers constitutifs d'établissement stable

L'Article 4 § 3 de la convention franco-belge précise en son paragraphe g) qu'un chantier de construction ou de montage ne constitue un établissement stable que si sa durée excède six mois. L'Article 2 - 3 - 2$^{o}$) - h) de la convention franco-luxembourgeoise en fait autant.

Il arrive toutefois que la même entreprise mène simultanément plusieurs chantiers en Belgique mais sur des sites différents et pour des clients différents.

Il semble que l'Administration belge, dans son appréciation de la durée des chantiers, ait tendance à considérer ceux-ci dans leur ensemble, c'est-à-dire cumuler les durées respectives de chacun d'eux pour déterminer s'il y a ou non établissement stable. Cette position est évidemment de nature à causer difficulté, et, soit dit en passant, va à l'encontre des normes de l'O.C.D.E. (cf. paragraphe 3-17 du commentaire du modèle de convention O.C.D.E. de 1977).

### 7. Problèmes concernant les "joint ventures" entre entreprises françaises et entreprises belges

Soit une association momentanée belge entre deux entreprises, l'une française, l'autre belge, aux fins d'une opération portant concurremment sur la France et sur la Belgique.

La partie française de l'opération est gérée par l'entreprise française, la partie belge par l'entreprise belge. Les deux parties sont associées à égalité dans les bénéfices de l'opération.

Selon l'Article 4.2 de la convention franco-belge, les bénéfices de l'Association doivent, en principe être imposé dans l'Etat où celle-ci a un établissement stable. Il s'ensuit que l'entreprise française se verra imposer en Belgique à raison de 50 pour cent de la fraction des bénéfices produits par l'établissement belge de l'Association et, vice versa, l'entreprise belge supportera l'impôt français à raison de 50 pour cent de la fraction des bénéfices se rapportant à l'établissement français.

Or, en raison des règles de territorialité applicables notamment en France, la part de bénéfices de l'entreprise française dans l'établissement stable de l'Association en Belgique ne saurait s'imputer sur les pertes de cette entreprise en France. Au surplus, les sommes perçues par chaque partie au titre de sa part dans les bénéfices de l'établissment sis dans l'autre état assujetti à retenue à la source tant en France qu'en Belgique respectivement.

Cela dit, il convient de reconnaître que la disposition particulière qui figure dans l'Article 4.2 de la convention ne fait, en réalité, que reprendre un principe de droit commun, en sorte que la situation ne serait pas différente en l'absence de pareille disposition.

Il n'en n'est pas moins vrai que le système auquel on aboutit en l'occurrence ne respecte pas la neutralité fiscale qui, comme dit ci-dessus, doit — surtout entre états membres de la Communauté Economique Européenne — être recherchée au-delà de toute préoccupation d'ordre national.

Aussi, dans la mesure où:

a) il est fait masse des bénéfices de l'Association dans son ensemble
b) les deux partenaires sont à égalité comme dit ci-dessus
c) les activités respectives des deux établissements sont sensiblement de même importance,
   une solution satisfaisante devrait pouvoir être trouvée à ce problème, en admettant de considérer que le partage des bénéfices de l'Association s'effectue entre les partenaires à raison de l'attribution de la totalité du profit afférent à l'établissement français à l'entreprise française et la totalité du profit afférent à l'établissement belge à l'entreprise belge.

En tout état de cause, ce cas illustre bien la double imposition à laquelle conduit techniquement l'application de la retenue à la source aux établissements stables.

## 8. Droits d'auteur, revenus de brevets et redevances diverses

Tant la convention franco-belge (Article 8-1) que la convention franco-luxembourgeoise (Article 10-2) prévoit, conformément à une norme actuellement bien établie, que les revenus en cause ne sont imposables que dans le pays de la résidence à condition que le bénéficiaire ne dispose pas dans le pays de la source d'un établissement stable ou d'une installation fixe intervenant dans l'exploitation des biens dont ces revenus sont le produit.

La convention franco-luxembourgeoise envisage dans son Article 10-3 le cas où, par suite de relations spéciales existant entre le débiteur et le créancier ou que l'un et l'autre entretiennent avec de tierces personnes, le montant des redevances payées, compte tenu de la prestation pour laquelle elle sont versées, excède celui dont seraient convenue le débiteur et le créancier en l'absence de pareilles relations. Elle précise, que dans ce cas, le principe de l'imposition dans le pays de la résidence du bénéficiaire ne s'applique qu'à ce dernier montant, la partie excédentaire des paiements devant être imposée, soit en tant que dividende, soit, à défaut, conformément aux autres dispositions de la convention selon la qualification retenue pour ces revenus.

Cette disposition n'appelle pas d'observation particulière.

Il n'en est pas de même des termes correspondants de la convention franco-belge (Article 8-2).

En effet, cette dernière convention contient à cet égard des dispositions particulières concernant certains cas, spécifiquement énumérés, dans lesquels la partie jugée excessive d'une redevance est "également" imposable dans l'état de la source, et ce, dans des conditions, qui méritent qu'on s'y arrête.

Pour la commodité de l'exposé, rappelons que les dispositions en cause, auxquelles se rattachent directement celles de l'Article 8-3, sont les suivantes:

> 8-2 — Nonobstant les dispositions du paragraphe 1 ci-dessus, les redevances, produits et droits y mentionnés sont également imposables dans l'Etat contractant sur le territoire duquel est située l'entreprise qui en supporte la charge:
>
> a) Lorsque et dans la mesure où suivant les pratiques de cet Etat, ces redevances, produits et droits excèdent un montant normal, compte tenu des usages commerciaux, de la valeur intrinsèque des biens visés audit paragraphe et du rendement global produit par l'utilisation de ces biens:
>
> b) Lorsque et dans la mesure où ces redevances, produits ou droits excèdent la quote-part — augmentée d'un droit normal — imputable à l'entreprise débitrice dans les dépenses et charges réelles assumées par l'entreprise bénéficiaire pendant la période d'imposition, pour l'acquisition le perfectionnement ou l'amortissement et la conservation des droits concédés ou cédés, dans le cas où l'une de ces entreprises est en fait sous la dépendance ou sous le contrôle de l'autre, ou encore lorsque ces deux entreprises sont en fait sous la dépendance ou sous le contrôle d'une tierce entreprise ou d'entreprise dépendant d'un même groupe.
>
> 8-3 — Dans les cas particuliers où il apparaît qu'il y a lieu de faire application des dispositions du paragraphe 2 ci-dessus, les autorités compétentes des deux Etats contractants s'entendent pour fixer la fraction du montant des redevances, produits et droits qui peut être considérée comme normale et pour éviter, conformément à l'esprit de la convention, la double imposition de la fraction desdits revenus qui a été soumise à l'impôt dans l'Etat contractant autre que celui dont le bénéficiaire est un résident.

Ces textes suscitent les observation suivantes:

a) Il y est indiqué que la portion jugée excessive des droits payés est "également" imposable dans l'état de la source.

Le mot "également" paraît indiquer que le principe d'une double imposition pour cette fraction est admise.

Certes, le paragraphe 8.3 prévoit une concertation entre les Administrations des deux Etats pour la fixation de la fraction excessive des droits en vue d'éviter une double imposition; mais il n'est pas exclu que ces administrations ne puissent parvenir à un accord ou du moins qu'elles n'y parviennent pas dans un délai raisonnable. Dans ce cas, c'est effectivement d'une double imposition qu'il s'agit, pour autant que l'administration de l'Etat de la source n'attendra pas l'intervention de l'accord pour procéder à son redressement.

Encore la convention franco-belge, contrairement à la convention franco-luxembourgeoise, ne précise-t-elle pas à quel titre (dividendes ou autre) la fraction excédentaire doit être imposée.

*Remarque*
(Il n'est pas inutile de remarquer en passant que les dispositions qui figurent au paragraphe 1.4. de l'Article 12 du modèle de Convention O.C.D.E. de 1977 n'est pas, lui non plus, satisfaisant à cet égard. Il se contente en effet, d'édicter que la partie excédentaire des paiements reste imposable selon la législation de chaque Etat contractant et compte tenu des autres dispositions de la présente Convention, y compris celles de l'Article 25 relatives à la procédure amiable. Il laisse donc totalement de côté les risques de double imposition, pour lesquels il n'envisage d'autre remède que celui d'une concertation amiable entre administrations.)

b) En ce qui concerne les termes du paragraphe 8-2-a, la référence à la valeur intrinsèque des biens dont les redevances en cause sont le produit, n'appelle aucune observation. En revanche, il n'en est pas de même du critère, qui y est également énoncé, du "rendement global produit par l'utilisation de ces biens".

Non seulement cette expression n'a pas un sens clair, mais encore, elle ne laisse pas d'être inquiétante. Signifie-t-elle que, pour apprécier le caractère normal ou excessif de la redevance, l'administration devrait rechercher quel est le rendement global produit par l'utilisation de ces biens dans l'entreprise qui en est propriétaire?

Or, non seulement, pareil critère est en soi discutable, mais, en outre, il va bien au delà des normes établies en France, — pour ne citer que notre pays — notamment par la jurisprudence des tribunaux.

Encore reste-t-il à se demander si — comme cela semble être le cas — la notion de "rendement global" inclut aussi bien l'exploitation directe que l'exploitation par voie de licence.

c) En ce qui concerne la disposition du paragraphe 8-2-b, il convient tout d'abord de remarquer que, alors même que, selon le paragraphe a, la redevance pratiquée serait normale en soi suivant les pratiques de l'état de la source, elle n'en pourrait pas moins être considérée comme anormale selon le paragraphe (b), dans le cas où elle se rapporte aux relations entre entreprises dépendantes (Il faut remarquer que le texte de la Convention modèle de l'O.C.D.E. ne fait pas cette distinction).

Corrélativement, on aperçoit mal en quoi la norme retenue dans un cas devrait différer de celle qui doit s'appliquer dans l'autre. En tout état de cause, le texte du paragraphe (b) résout, d'une façon que pourrait qualifier de très hardie, le problème — certes délicat — des licences de propriété industrielle entre entreprises dépendantes.

Encore à cet égard, la Convention va au delà du droit national, en tout cas pour ce qui concerne le droit français.

d) Ce paragraphe se justifie mieux et n'appelle aucun commentaire particulier.

e) En ce qui concerne le paragraphe 8-3, nous avons déjà fait observer ci-dessus qu'il peut arriver que les Administrations ne parviennent pas à s'entendre sur la détermination de la fraction de la redevance qui doit être considérée comme excessive ou qu'elles n'y parviennent pas dans un délai raisonnable. Pareille hypothèse se traduira vraisemblablement par une double imposition.

Mais, en admettant même que la concertation aboutisse, les réserves suivantes s'imposent, à savoir:
— En premier lieu, l'Article 8-3 ne prévoit de discussion qu'entre les deux Administrations sans aucune intervention possible des intéressés. Certes, en pratique, on ne saurait douter qu'ils seront admis à donner toutes explications et faire toutes observations, mais en principe, ils n'ont pas voix au chapitre.
— Surtout, la question se pose de savoir de quel recours les intéressés pourront disposer à l'encontre de la décision commune des Administrations.
  En effet, s'il est vrai que l'Article 24-3 de la Convention prévoit une procédure amiable, ce n'est qu'en cas de double imposition. Or, l'accord entre les deux Administrations prévu par l'Article 8-3 est précisément censé éviter la double imposition. Il s'ensuit que les parties intéressées ne pourront effectivement que s'incliner devant cette détermination concertée en dehors d'eux.

## 9. En ce qui concerne les sociétés holding luxembourgeoises

Un problème se pose aux banques françaises chargées de payer des coupons de dividende ou des intérêts. Ce problème réside dans le fait que la banque n'a pas les moyens de s'assurer du statut de la société à laquelle les dividendes ou intérêts sont payés au Luxembourg, en sorte qu'elle risque d'ignorer son statut de holding et d'appliquer les dispositions de la convention franco-luxembourgeoise dont les holdings sont exclus.

Lorsqu'une formule lui est présentée, la banque française accorde en principe le bénéfice de la Convention. A cet égard, elle ne peut que s'en remetttre à l'attestation de l'Administration Fiscale Luxembourgeoise. Cette attestation est censée avoir été délivrée régulièrement à une société n'ayant pas le statut de holding.

Cependant, il arrive que la société produise la formule dûment certifiée prévue pour l'attribution de l'avoir fiscal sur les dividendes de sociétés françaises alors que, manifestement, en raison du montant des coupons à lui payer, elle n'a pas droit à cet avoir fiscal réservé aux sociétés luxembourgeoises ayant moins de 25 pour cent du capital de la société distributrice. Dans ce cas, la formule est renvoyée au correspondant étranger qui est invité à présenter une formule appropriée (donnant droit à la seule réduction du taux de la retenue à la source française et éventuellement au remboursement du précompte.)

## Observations de la section belge du groupement belgo-luxembourgeois de l'association internationale de droit fiscal concernant certains points de la convention franco-belge qui devraient, à son estime, faire l'objet d'une révision*

### 1. Statut fiscal des associés belges des sociétés immobilières françaises fiscalement transparentes

Certaines sociétés civiles immobilières françaises jouissent, sur le plan du droit commun, de la personnalité juridique mais sont considérées fiscalement comme inexistantes. Leurs bénéfices sont dès lors taxés directement dans la personne de leurs associés, selon le régime des revenus immobiliers et sans qu'il soit fait de distinction entre les bénéfices distribués et les bénéfices réservés mais étant entendu que si des bénéfices réservés, taxés fictivement à charge des associés, sont ultérieurement distribués, ils ne donnent plus ouverture à l'impôt en France.

La loi belge ne connait pas, sauf cas exceptionnels et moyennant l'accord préalable des intéressés, la taxation des bénéfices réservés d'une société dans la personne de ses associés, ce qui, il faut le reconnaître, peut entrainer pour les intéressés, des sérieuses difficultés, notamment sur le plan du financement de l'impôt.

Par ailleurs, la loi belge ne reconnaît pas non plus la validité en Belgique des fictions des lois fiscales étrangères, à moins que ces fictions ne soient expressément étendues à la Belgique par une convention internationale.

De ce fait, les bénéfices *réservés* des sociétés françaises fiscalement transparentes ne sont pas considérés en Belgique comme des revenus taxables à charge de leurs associés belges.

Par contre, les revenus *distribués* de ces sociétés sont taxés en Belgique dans la personne de leurs associés belges, au titre de revenus mobiliers, sans qu'il soit tenu compte de l'impôt déjà payé par eux en France, la même année ou au moment de la constitution des réserves. Ces revenus distribués sont assujettis au régime ordinaire des dividendes, c'est-à-dire bénéficient seulement d'une déduction de 15 pour cent au titre de quotité forfaitaire d'impôt étranger.

La solution normale de ce problème aurait été que la convention franco-belge en vue d'éviter les doubles impositions, tout en reconnaissant à la France le droit exclusif de taxation sur les revenus des sociétés immobilières françaises fiscalement transparentes, reconnaisse le caractère de revenus immobiliers — qu'ils ont dans la réalité économique — aux revenus *distribués* par ces sociétés et leur applique le régime prévu pour les revenus immobiliers, c'est-à-dire qu'ils soient exonérés en Belgique mais pris en considération pour déterminer le taux de l'impôt applicable aux autres revenus du bénéficiaire.

Il est regrettable qu'au lieu d'appliquer cette formule et de respecter ainsi les principes qui sont à la base de la convention, c'est-à-dire taxation exclusive des revenus immobiliers dans le pays de la source, l'article 2 du protocole final de la convention franco-belge sur les doubles impositions énonce au contraire que: "L'article 15, § 1 — qui concerne les revenus mobiliers — ne s'oppose pas à ce que la France, conformément aux dispositions de sa loi interne, considère comme des biens immobiliers, au sens de l'article 3 de la convention, les droits sociaux possédés par les associés ou actionnaires des sociétés qui ont en fait pour unique objet soit la construction ou l'acquisition d'immeubles ou de groupes d'immeubles en vue de leur division par fractions destinées à être attribuées à leurs membres en propriété ou en jouissance, soit la gestion de ces immeubles ou groupes d'immeubles ainsi divisés. La Belgique pourra toutefois imposer, dans les limites fixées aux articles 15, §§ 1 et 2 et 19-a, § 1, les revenus tirés par des résidents de la Belgique de droits sociaux représentés par des actions ou parts dans lesdites sociétés résidentes de la France".

Cette disposition devrait être modifiée et il devrait être, au contraire, prévu que les dividendes distribués par des sociétés immobilières françaises fiscalement transparentes seront traités en Belgique comme des revenus immobiliers, comme ils le sont en France.

N.B.: Voir en ce qui concerne le principe de l'exclusion des bénéfices *réservés* des sociétés immobilières françaises fiscalement transparentes de la

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* Le présent rapport est l'oeuvre collective de Messieurs André BUELINCKX (Compagnie Bruxelles-Lambert pour la finance et l'industrie, membre du Comité scientifique du groupe belgo-luxembourgeois de l'I.F.A.), Henri LEVY-MORELLE (chef des services juridiques de SOLVAY et Cie, professeur à l'Université de Bruxelles, Vice-président du Comité directeur de la section belgo-luxembourgeoise de l'I.F.A.) et Guy VAN FRAEYENHOVEN (avocat — chargé de cours à l'Université de Louvain — membre du Comité scientifique de groupe belgo-luxembourgeois de l'I.F.A.). Coordinateur: Jean de LONGUEVILLE (avocat — président de la Commission scientifique du groupement belgo-luxembourgeois de l'I.F.A.).

base imposable des associés belges de semblables sociétés en Belgique, l'arrêt de la Cour d'appel de Bruxelles du 10 juin 1974. L'administration s'est inclinée devant cet arrêt qui a donc fixé la jurisprudence mais qui a laissée entier le point de savoir si les bénéfices *distribués* de ces société sont à considérer en Belgique comme des revenus mobiliers ou comme des revenus immobiliers, problème qui, à dire vrai, paraît réglé par l'article 2 du protocole dans un sens défavorable au contribuable.

## 2. Statut fiscal des plus-values immobilières ou assimilées

La législation française, comme la législation belge, assimile à des revenus, taxables selon des modalités variables, les plus-values réalisées sur certain biens immeubles, et notamment sur les terrains.

Ces plus-values sont, en vertu de l'article 3, alinéa 4 de la convention franco-belge en vue d'éviter les doubles impositions, taxables dans le pays où se trouve l'immeuble cédé.

Sur ce terrain, il n'y a donc pas de problèmes.

La législation française, à la différence de la législation belge, assimile à des plus-values immobilières, les plus-values réalisées lors de la cession de parts des sociétés civiles immobilières transparentes ou d'actions ou parts des sociétés civiles immobilières de toute nature autres que les sociétés transparentes, dont le patrimoine est composé essentiellement par des immeubles autres que des terrains à usage agricole ou forestier (cfr. loi du 15 mars 1963 et la loi du 19 décembre 1963 modifiée ou remplacée par la loi du 19 juillet 1976).

L'administration française, se basant sur l'article 3, alinéa 2 de la convention franco-belge, aux termes duquel "la notion de bien immobilier se détermine d'après les lois de l'Etat contractant où est situé le bien considéré" et sur le numéro 2 du protocole final, ci-avant reproduit, assimile à des biens immobiliers et taxe dès lors en France les plus-values sur titres réalisées par les associés belges des sociétés immobilières françaises, qu'elles soient ou non fiscalement transparentes.

Le commentaire administratif français énonce à ce sujet que: "Eu égard à ces généralités, l'expression "les lois de l'Etat contractant" doit être interprétée comme comprenant aussi bien le droit fiscal que le droit civil" et que: "le § 2 du protocole susvisé n'ayant pas un caractère limitatif, il convient de considérer que le même caractère doit être reconnu aux droits détenus dans les sociétés dont l'actif est constitué principalement par les terrains à bâtir ou des biens assimilés (article 3 de la loi no. 63-1241 du 19 décembre 1963) ainsi qu'aux droits détenus dans des sociétés civiles immobilières de toute nature — autres que celles dites de la transparence fiscale — et dont le patrimoine est composé essentiellement par des immeubles autres que des terrains à usage agricole ou forestier (article 4-11 de la loi du 19 décembre 1963)".

L'administration belge, de son côté, considère les plus-values de l'espèce comme des plus-values *mobilières*, les considère à ce titre comme réalisées en Belgique lorsqu'elles affectent des titres appartenant à des résident de la Belgique et les taxe selon le régime prévu pour les plus-values de l'espèce sans avoir égard à l'impôt payé en France (cfr. Commentaire général des conventions en vue d'éviter les doubles impositions no. 13/245 au Bulletin des contributions no. 538 et 23/125 du Bulltin des contributions no. 548).

N.B.: Il est à remarquer que si le no. 2 du protocole de la convention franco-belge prévoit le droit pour la Belgique d'imposer "dans les limites fixées aux articles 15-19-a § 1er, les *revenus* tirés par des résidents de la Belgique de droits sociaux représentés par des actions ou parts dans les sociétés qui ont en fait pour unique objet soit la construction ou l'acquisition d'immeubles ou de groupes d'immeubles en vue de leur division par fractions destinées à être attribuées à leurs membres en propriété ou en jouissance soit la gestion de ces immeubles ou groupes d'immeubles ainsi divisés", cette disposition paraît, contrairement à l'opinion exprimée par l'administration française, étrangère aux sociétés immobilières *non-transparentes* ainsi qu'aux *plus-values* provenant de la cession d'actions ou parts dans les sociétés immobilières françaises, transparentes ou non.

Ce problème devrait être revu et il devrait être prévu que les plus-values obtenues par un détenteur belge d'actions ou parts des sociétés immobilières françaises en cause sont, éventuellement taxables exclusivement en France, au titre de plus-values ou revenus immobiliers.

## 3. Discriminations existant en matière de déduction au titre de charges professionnelles des intérêts bancaires payés par un débiteur belge selon que ces intérêts sont payés à une banque belge ou à une banque française ou grand-ducale

La législation fiscale belge présume anormal et rejette à ce titre des dépenses professionnelles de l'emprunteur l'intérêt qui dépasse une certaine quotité, même si, en fait, cet intérêt est normal compte tenu de l'état du marché financier.

Le taux admis est le taux d'intérêt pratiqué par la Banque Nationale de Belgique pour les avances et prêts sur effets publics autres que les certificats de trésorerie, majorés de trois points, avec minimum de 9 pour cent.

La loi belge du 23 janvier 1975 a toutefois prévu qu'à partir du 1er janvier 1974, aucune limitation ne serait applicable en ce qui concerne les sommes payées au titre d'intérêts aux banques belges et autres institutions de crédit établies en Belgique, y compris les établissements stables belges des banques et établissements de crédit étrangers.

La loi belge crée ainsi une discrimination entre les banques ou établissements de crédit belges, y compris les établissements stables de banques ou établissements de crédit étrangers, et les établissements étrangers, notamment français (ou grand-ducaux).

Elle fausse dès lors le marché financier, ce qui apparaît comme une violation de l'article 67 du Traité de Rome aux termes duquel les Etats membres ne peuvent maintenir au-delà de la période de transition — laquelle est passée depuis longtemps — des discriminations de traitement fondées sur la nationalité ou la résidence des parties ou sur la localisation du placement.

Elle crée par ailleurs une double imposition économique. L'établissement de crédit créancier étranger est en effet taxé à l'étranger sur l'intégralité de l'intérêt perçu, y compris la partie présumée anormale de celui-ci, tandis que cette partie présumée anormale est taxée également dans le chef de l'emprunteur en Belgique, au titre de charges professionnelles rejetées.

Il conviendrait qu'il soit porté remède à cette situation anormale, la solution la plus adéquate étant, semble-t-il, que l'intérêt ne puisse être rejeté des dépenses professionnelles du débiteur que s'il est véritablement anormal, compte tenu de l'état du marché financier et, donc, la suppression d'une présomption légale qui s'est révélée à diverses reprises ces derniers temps, ne pas correspondre à la réalité économique et être une source de distorsions et une entrave à la bonne marche des entreprises.

## 4. Bonification de l'avoir fiscal français aux sociétés belges, actionnaires ou associées de sociétés françaises

Le Gouvernement français s'est déclaré favorable à des négociations avec les principaux Etats intéressés en vue d'établir, par voie conventionnelle, un système assurant aux non-résidents qui sont effectivement soumis à l'impôt dans leur pays sur des dividendes distribués par une société française, un régime analogue à celui des actionnaires domiciliés en France, qui bénéficient de l'avoir fiscal.

L'avenant du 15 février 1971 à la convention franco-belge ne prévoit cependant pas le remboursement de l'avoir fiscal aux sociétés belges. A l'époque, les dividendes encaissés par les sociétés belges étaient exonérés pour leur quasi totalité de l'impôt des sociétés au titre de revenus déjà taxés. Le régime interne belge a toutefois été modifié depuis lors par la loi du 25 juin 1973, articles 31 à 34. Actuellement, les sociétés ne bénéficient du régime des revenus déjà taxés que pour les dividendes afférents à des participations "permanentes". Les dividendes afférents à des participations "non-permanentes" dans des sociétés françaises sont dès lors assujettis au régime ordinaire de l'impôt des sociétés et il conviendrait qu'ils bénéficient de l'avoir fiscal français.

Il en est de même en ce qui concerne les bonis de liquidation qui sont assujettis par la loi française au régime des dividendes et taxés en Belgique au titre de plus-values sur avoirs investis, sans que les sociétés belges, actionnaires ou associées de sociétés françaises en liquidation, bénéficient en France de l'avoir fiscal, au motif qu'elles ne seraient pas taxables en Belgique, alors qu'elles le sont (voir ci-après pour de plus amples explications à ce sujet).

La convention franco-belge devrait être aménagée de façon à tenir compte de ces situations.

## 5. Statut fiscal des établissements stables exploités en France par des sociétés belges et des établissements stables belges des sociétés françaises

Ce statut présente les anomalies suivantes:

a) l'établissement stable français d'une société belge qui détient une participation dans une société française et qui bénéficie de ce chef de dividendes qu'il enregistre, obligatoirement, dans sa comptabilité propre, subit deux fois l'impôt en France sur ces dividendes.

   En effet, ceux-ci sont taxés une première fois à l'impôt des sociétés dans le chef de la société française, filiale de l'établissement stable et une seconde fois dans le chef de celui-ci, le régime spécial prévu pour les sociétés mères par les articles 145, 146 et 205 du Code général des impôts étant exclusivement réservé aux sociétés mères françaises et ne s'appliquant donc pas aux établissements stables françaises de sociétés étrangères, y compris les sociétés belges.

   Ce régime constitue une discrimination entre contribuables français et contribuables belges se trouvant dans la même situation. Il est donc directement contraire au principe fondamental de l'égalité de traitement.

   Il est à remarquer que les sociétés françaises qui exploitent un établissement stable belge ne souffrent pas d'une pareille différence de traitement. En effet, l'article 111 du Code belge des impôts sur les revenus, qui prévoit une déduction "revenus de revenus" de 90 ou de 95 pour cent (suivant que la société mère est ou non une holding) des dividendes produits par des participations dites "permanentes" dans des sociétés belges s'applique aussi bien aux établissements belges de sociétés françaises qu'aux sociétés mères belges.

b) aussi bien en Belgique qu'en France, les établissements stables de sociétés étrangères subissent l'impôt des sociétés sur l'intégralité de leurs bénéfices à un taux discriminatoire par rapport aux entreprises nationales au motif que les bénéfices de ces établissements stables concourent à la formation du bénéfice global de la société étrangère et que la distribution de ce bénéfice entre les actionnaires ou associés de cette société donnera ouverture à l'étranger à une taxation complémentaire dont le pays de l'établissement stable ne pourra bénéficier.

   En Belgique, la récupération de l'impôt frappant les distributions présumées du bénéfice provenant de l'établissement stable se fait sous forme d'une augmentation du taux de l'impôt des sociétés qui est plus lourd pour les établissements stables de sociétés étrangères que pour les sociétés belges.

   En France, l'article 115 quinquies 1° du Code général des impôts énonce que les bénéfices réalisés par les établissements stables français de sociétés étrangères sont réputés distribués, au titre de chaque exercice, à des associés non-résidents. Le bénéfice distribué est présumé être égal au montant total des bénéfices, imposables ou exonérés, après déduction de l'impôt des sociétés.

La loi française autorise toutefois la société étrangère à demande la révision de la base imposable à la retenue à la source et donc d'obtenir une restitution totale ou partielle de la retenue en démontrant soit que les sommes auxquelles la retenue a été appliquée excèdent le montant total des dividendes effectivement distribués par la société étrangère, soit que ces dividendes ont bénéficié en tout ou en partie à des résidents français mais ce tempérament est source de complications considérables et ne constitue pas un remède adéquat à la discrimination que représente une retenue à la source basée sur la présomption que la totalité des bénéfices réalisés par un établissement stable français d'une société étrangère sont effectivement distribués par celle-ci à ces actionnaires.

Si l'on s'en réfère aux diverses conventions en vue d'éviter les doubles impositions conclues par la France, on constate que celles-ci, tout en maintenant le principe de la retenue à la source sur les bénéfices des établissements stables de sociétés étrangères, a accepté, avec réciprocité, certain aménagements à la rigueur de sa législation interne.

Ces aménagements comportent soit une réduction de la base de calcul de la retenue à la source, soit une réduction du taux, soit les deux.

Exprimée en pourcentages du bénéfice net de l'établissement stable français, la retenue à la source est, pour les principaux pays de la Communauté Economique Européenne avec lesquels la France a conclu une convention, la suivante:

0 pour cent pour l'Allemagne et les Pays-Bas;
5 pour cent pour la Belgique (10 pour cent d'une base ramenée à 50 pour cent) et pour le Luxembourg (5 pour cent d'une base de 100 pour cent);
6,25 pour cent pour l'Italie (25 pour cent d'une base de 25 pour cent);
10 pour cent pour la Grande-Bretagne (15 pour cent d'une base réduite aux 2/3);
25 pour cent pour le Danemark et l'Irlande.

Comme dit ci-avant, la Belgique ne connaît pas la retenue à la source sur les bénéfices réalisés par les établissements stables belges de sociétés étrangères mais elle leur applique en droit interne, un taux d'impôt des non-résidents supérieur au taux normal de l'impôt des sociétés frappant les sociétés belges. Le taux de base de l'impôt des non-résidents applicable aux établissements belges de sociétés étrangères est en effet de 54 pour cent alors que le taux de l'impôt des sociétés est de 48 pour cent.

Compte tenu des conventions conclues par la Belgique avec les pays membres de la Communauté Economique Européenne, le taux applicable aux établissements belges de sociétés résidentes de ces pays est le suivant:

taux normal de l'impôt des sociétés: Allemagne, Danemark, Italie;
taux normal de l'impôt des sociétés majoré de 5 points: Grande-Bretagne, Irlande;
taux normal de l'impôt des sociétés majoré de 10 pour cent sur la moitié du bénéfice de l'établissement après impôt au taux normal de l'impôt des société: France, Luxembourg, Pays-Bas;

ce qui donne donc une imposition de 48 pour cent pour l'Allemagne, le Danemark et l'Italie, de 53 pour cent pour la Grande-Bretagne et l'Irlande et de 50,6 pour cent pour la France, le Luxembourg et les Pays-Bas.

Il serait souhaitable que dans le cadre de concessions réciproques et pour éviter les complications auxquelles donne lieu le système actuel français, la Belgique et la France s'entendent pour supprimer la retenue à la source appliquée par l'Etat français sur les bénéfices des établissements stables français de sociétés belges et pour que la Belgique applique, de son côté, le taux normal de l'impôt des sociétés aux bénéfices des établissements stables belges de sociétés françaises.

Cette solution s'impose non-seulement en raison de la simplification qu'elle implique mais encore parce que la présomption selon laquelle des bénéfices réalisés par l'établissement stable d'une société étrangère sont effectivement distribués ne correspond, dans de nombreux cas, plus à aucune réalité dans l'état actuel des choses et que le supplément d'impôt réclamé tant par la France que la Belgique aux établissements stables de sociétés étrangères est dès lors injustifié.

Il est à remarquer qu'aussi bien le système belge que le système français sont une source de double imposition caractérisée, aucun des deux pays ne tenant compte du supplément d'impôt grevant les établissements stables étrangers de leurs sociétés nationales lors de l'établissement de l'impôt grevant les dividendes éventuellement distribués par celles-ci.

### 6. Bonification du crédit d'impôt belge aux actionnaires ou associés français de sociétés belges

Le remède apporté par la législation belge, dans une mesure d'ailleurs insuffisante, à la double imposition résultant du fait que le bénéfice distribué d'une société belge est taxé à la fois à charge de la société distributrice et à charge de ses actionnaires ou associés, est le suivant:

— si l'actionnaire ou l'associé est une société, le précompte mobilier qui a été retenu au moment du paiement du dividende ou de la participation bénéficiaire est imputé sur l'impôt des sociétés ou lui est restitué. Par ailleurs, le dividende perçu est exclu de son revenu taxable à l'impôt des sociétés à concurrence de 90 ou de 95 pour cent suivant qu'il s'agit ou non d'une holding. Les dividendes distribués par cette société sont intégralement taxables.

— s'il s'agit d'une personne physique, le précompte mobilier perçu au moment de l'attribution du dividende est imputé sur son impôt des personnes physique ou lui est, le cas échéant, restitué; le dividende perçu est compris dans la base imposable à l'impôt des personnes physiques mais un "crédit d'impôt" est imputé sur la partie de l'impôt des personnes physiques correspondant au dividende perçu, sans toutefois être resitué à l'actionnaire s'il lui est supérieur; le précompte mobilier et le crédit d'impôt sont ajoutés au dividende net pour déterminer le revenu taxable.

En ce qui concerne les actionnaires ou associés français de sociétés belges, le précompte mobilier est calculé au taux réduit prévu par la convention (15 pour cent). Le précompte mobilier est compensé en France par une réduction correspondante de l'impôt français. De ce côté, il n'y a donc pas de problèmes.

La Belgique n'accorde par contre aucune bonification aux actionnaires ou associés étrangers des sociétés belges du chef de l'impôt des sociétés supportés par celles-ci, au motif qu'en ce qui concerne les sociétés, la méthode prévue c'est-à-dire la déduction "revenu de revenu" n'est susceptible de s'appliquer que pour autant qu'il s'agisse de sociétés assujetties en Belgique à l'impôt des sociétés, ce qui n'est évidemment pas le cas des sociétés étrangères n'ayant pas d'établissement stable en Belgique et qu'en ce qui concerne les personnes physiques le crédit d'impôt dont bénéficient les résidents belges n'est pas remboursable mais peut seulement être imputé sur l'impôt des personnes physiques ou des non-résidents dû par eux. Elle invoque également le fait que le crédit d'impôt est forfaitaire, c'est-à-dire indépendant de l'impôt des sociétés effectivement payé par la société ayant attribué les dividendes.

Ce point de vue est peut-être fondé sur le plan purement juridique mais il est profondément inéquitable sur le plan économique et générateur d'une double imposition caractérisée, l'actionnaire ou l'associé étranger d'une société belge étant taxé à l'étranger et notamment en France sans qu'il soit tenu compte de la lourde charge fiscale déjà supportée en Belgique par la société ayant attribué le dividende qui supporte ainsi une charge fiscale proche de 100 pour cent.

Ce problème devrait être sérieusement repensé et la convention franco-belge en vue d'éviter les doubles impositions devrait prévoir que la Belgique attribuera un crédit d'impôt aux actionnaires résidents français de sociétés belges, qu'il s'agisse de sociétés ou de personnes physiques, comme le fait la France (étant entendu que, comme exposé ci-avant, la France devrait l'accorder également aux sociétés belges actionnaires de sociétés françaises pour lesquelles les dividendes ou bonis de liquidation perçus en France constituent un revenu taxable).

## 7. Statut fiscal des liquidations de sociétés (belges ou françaises)

On se trouve, ici encore, en présence d'une double imposition caractérisée à laquelle la convention franco-belge en vue d'éviter les doubles impositions n'a pas apporté de solution adéquate. Cette double imposition provient essentiellement de ce que les bonis de liquidation sont considérés en France comme des dividendes tandis qu'ils sont considérés en Belgique comme des plus-values sur avoirs investis.

Le régime fiscal applicable en France aux sociétés en liquidation et à ses associés ou actionnaires est, sauf erreur, le suivant:

a) la société en liquidation est assujettie à l'impôt des sociétés selon le régime de droit commun sur les profits ou plus-values obtenus en cours de liquidation (article 221-2 du Code général des impôts);

b) les sommes réparties entre les actionnaires ou associés sont considérées comme un produit d'actions ou de parts sociales dans la mesure où elles excèdent les apports effectivement libérés (article 111 bis du Code général des impôts et instructions du 24 février 1966, § 2 commentant la loi 65-566 du 12 juillet 1965). Elles donnent dès lors droit à l'avoir fiscal (article 158 bis du Code général des impôts);

c) si l'actionnaire ou l'associé est une personne physique résidant en France, le boni de liquidation, c'est-à-dire la différence entre la valeur nominale de la part ou de l'action et la somme distribuée, n'est compris dans la base imposable du bénéficiaire qu'à concurrence de la différence entre le remboursement obtenu et le prix d'acquisition de la part ou de l'action (article 161 du Code général des impôts). L'avoir fiscal n'est, dans ce cas, accordé que pour la partie imposable et en proportion de celle-ci;

d) si l'actionnaire ou l'associé est une société passible de l'impôt des sociétés, la difference entre la somme reçue et la valeur nominale de l'action ou de la part est considérée comme un revenu mobilier et la société bénéficie de l'avoir fiscal correspondant. Si la valeur d'acquisition de l'action a été inférieure à la valeur nominale, la différence entre cette valeur d'acquisition et la valeur nominale est taxée selon le régime ordinaire des plus-values, le solde étant assujetti au régime des dividendes. Si la somme reçue de la liquidation est moins élevée que la valeur d'acquisition de l'action ou de la part, il y a perte et donc pas de taxation;

e) si l'actionnaire ou l'associé est un "non-résident", qu'il s'agisse d'une personne physique ou d'une société, l'article 161 du Code général des impôts ne s'applique pas. Le boni de liquidation taxable est toujours égal à la différence entre la valeur nominale du titre ou de la part et la somme distribuée et ce boni est soumis à la retenue à la source de 25 pour cent, celle-ci étant, en ce qui concerne les actionnaires ou associés belges de sociétés françaises en liquidation, ramené à 15 ou 10 pour cent suivant le cas (article 15, § 2 de la convention);

f) si l'actionnaire ou l'associé belge est une personne physique, il a droit au remboursement de l'avoir fiscal (article 15, § 3 de la convention) mais il n'en est pas de même lorsque l'actionnaire ou l'associé est une société (voir ci-avant).

Rien n'est prévu en Belgique en ce qui concerne les plus-values obtenues par les actionnaires ou associés, résidents belges, d'une société étrangère en liquidation.

Cette plus-value n'est, en vertu des principes généraux du droit interne, pas taxable si elle affecte des actions faisant partie d'un patrimoine privé.

Elle est intégralement taxable, selon le régime de droit commun, si elle affecte des actions ou parts investies dans un patrimoine professionnel. Cette taxation est établie sans qu'il soit tenu compte, directement, des impôts perçus en France (impôt des sociétés ou retenue à la source), la disposition légale française assimilant les bonis de liquidation à un dividende n'ayant pas d'équivalent en Belgique et l'administration belge n'acceptant pas, si l'on en juge par les circulaires qui traitent de ce problème, de considérer les plus-values sur titres étrangers comme des revenus réalisés et taxés à l'étranger et de les assujettir, à ce titre, à un impôt réduit (voir commentaire général sur les conventions no. 10/304, 10/313, 0/18, 23/103, 23/124, 23/126 et 127, 23/175).

Le régime applicable en Belgique aux sociétés en liquidation est très différent. Il peut se résumer, très sommairement, comme suit:

a) une société en liquidation n'est plus considérée comme une exploitation et les plus-values éventuellement réalisées par elle après sa mise en liquidation ne donnent donc plus ouverture à l'impôt ordinaire des sociétés. Il est toutefois dérogé à ce principe en ce qui concerne certaines plus-values réalisées par des sociétés immobilières en liquidation;

b) au moment de la distribution, les sommes distribuées sont soumises, à charge de la société, à un impôt des sociétés spécial dit "impôt de liquidation", dans la mesure où elles dépassent les apports effectivement libérés, éventuellement revalorisés. Le taux de cet impôt varie suivant que les sommes distribuées correspondent aux réserves existant au jour de la mise en liquidation ou à des profits obtenus en cours de liquidation;

c) si l'actionnaire ou l'associé est une personne physique, la différence éventuelle entre le prix d'acquisition de ses actions ou parts et la somme reçue est intégralement exonérée;

d) s'il agit d'une société, les somme reçues sont considérées comme un revenu déjà taxé et la plus-value éventuellement obtenue est exonérée à concurrence de 90 ou de 95 pour cent selon qu'il s'agit ou non d'une société holding.

Dans ce système, aucune différence n'est faite selon que l'actionnaire ou l'associé est belge ou étranger. L'impôt frappant les bonis de liquidation, s'il en est, est supporté par la société en liquidation à la décharge de ses actionnaires ou associés et ceux-ci sont exonérés, totalement (en ce qui concerne les personnes physiques ou les non-résidents, personnes physiques ou sociétés) ou pour la quasi totalité (en ce qui concerne les sociétés belges), la loi assimilant la plus-value éventuellement obtenue par l'actionnaire ou l'associé (c'est-à-dire la différence et la somme reçue par lui en contrepartie de ses actions ou parts entre son prix d'acquisition ou d'investissement) et le boni de liquidation, c'est-à-dire la différence entre les apports effectivement libérés de la société en liquidation (éventuellement revalorisés) et les sommes distribuées par elle.

La convention franco-belge autorise expressément la Belgique à appliquer son droit interne et donc à prélever la cotisation spéciale dite "impôt de liquidation" sur les bonis de liquidation des sociétés belges, sans qu'aucun régime spécial soit prévu au profit des associés ou actionnaires résidents de la France (protocole final, 3).

La France considère le boni de liquidation comme un dividende, au sens de l'article 15, § 5 de la convention, pour lequel la limitation de l'impôt en Belgique est écartée par le protocole final 3. En application de l'article 19 B, 1, a, le bénéficiaire français d'un boni de liquidation provenant d'une société belge est soumis à l'impôt sur son boni net (c'est-à-dire sur la différence entre la valeur d'investissement de ses parts ou actions et la somme obtenue) majoré de la retenue de 15 pour cent ou de 10 pour cent présumée avoir été faite en Belgique (protocol final 5) et il peut imputer cette retenue fictive sur l'impôt français, calculé selon le droit interne français, proportionnellement afférent au boni imposable. L'excédent éventuel de retenue fictive n'est pas remboursable et il n'y a pas d'avoir fiscal.

Le système n'est pas satisfaisant et laisse subsister d'importantes doubles impositions économiques. Le problème devrait donc être revu et des modifications devraient être apportées à la convention franco-belge, afin de porter remède à la situation.

## DISCUSSION GENERALE *

*De commun accord il fut décidé que le plan de travail de cette journée serait conforme à celui de la convention modèle de double imposition rédigée à l'initiative de l'O.C.D.E.*

*Monsieur Kerlan (représentant l'administration française) fit remarquer préalablement à l'ouverture des débats que la convention franco-luxembourgeoise de 1958 fut prise alors que la doctrine internationale n'était qu'en cours d'élaboration et que les négociations de la convention franco-belge de 1964 datent de la même époque.*

## I. PERSONNES VISEES

N.B. Il y a lieu de remarquer que la nation de "personnes visées" ne souleva aucune question lors de la rédaction des rapports préalables à la journée d'étude mais suscita bien des controverses au cours des discussions en raison principalement des controverses découlant de la législation française.

L'article 3, 1, b, de la convention modèle prévoit que: "le terme "société" désigne tout personne morale ou toute entité qui est considérée comme une personne morale aux fins d'imposition; . . . . . . ".

* Notes réunies par:
J.P. Nemery de Bellevaux
M. Cozian
J. Malherbe
J. Autenne

*Question: qu'en est-il des sociétés de personnes (Me Goldsmith — France)?*

*A. Belgique*

Les sociétés de personnes constituent " . . . une individualité juridique distincte de celle des associés" (article 2 des L.C. sur les sociétés commerciales).

Le Code des impôts sur les revenus leur offre la possibilité " . . . (d') opter pour l'assujettissement de leur bénéfice à l'impôt des personnes physiques dans le chef de leurs associés . . . . " (art. 95).

*B. Luxembourg*

L'article 14 de la loi du 10.8.1915 prévoit que: "la société en nom collectif est celle qui existe sous une raison sociale et dans laquelle tous les associés sont indéfiniment et solidairement responsables".

Toutefois, la société en nom collectif et la société en commandite simple ne constituent pas une société à part entière en droit fiscal. Leurs bénéfices sont soumis à l'impôt sur le revenu des personnes physiques dans le chef de chacun de leurs associés et à l'impôt commercial communal dans le chef de l'entreprise "collective" elle-même (voyez Collection Jupiter, V, régimes fiscaux, 12-1).

*C. France*

La loi française prévoit que la société en nom collectif et la société en commandite simple jouissent de la personnalité juridique à dater de leur immatriculation au registre du commerce (loi n° 66.537 du 24.7.1966, art. 1 et 5).

L'article 239 du Code général des impôts prévoit que les sociétés en nom collectif, les sociétés en commandite simple et les associations en participation peuvent opter dans des conditions déterminées par arrêté ministériel pour le régime applicable aux sociétés de capitaux, l'option s'exerce donc dans un sens contraire à celle prévue par la loi belge pour les sociétés de personnes. Lorsqu'elle est exercée, elle est irrévocable (art. 239 du Code).

A côté des "associations en participation" qui ne disposent pas de la personnalité morale (idem, art. 419) la législation française connaît la notion de "groupement d'intérêt économique" ou en abrégé G.I.E. (ordonnance no 76.821 du 23.9.1967). La définition légale de G.I.E. prévoit: "Deux ou plusierus personnes physiques ou morales peuvent constituer entre elles, pour une durée déterminée, un G.I.E. en vue de mettre en oeuvre tous les moyens propres à faciliter ou à développer l'activité économique de ses membres, à améliorer ou à accroitre les résultats de cette activité" (art. 1).

Ces G.I.E. jouissent de la personnalité morale et " . . . . de la pleine capacité . . . " à dater de leur immatriculation au registre du commerce (art. 3).

En droit fiscal un G.I.E. ne constitue pas une société à part entière. L'article 19 de l'ordonnance citée prévoit que chacun des membres est personnellement passible pour la part des bénéfices correspondant à ses droits soit à l'impôt sur le revenu des personnes physiques, soit de l'impôt des sociétés s'il s'agit de personnes morales assujetties à cet impôt. La même disposition prévoit que la répartition du bénéfice est effectuée suivant les conditions fixées par la convention de groupement ou, à défaut, par fractions égales.

Les différences de législations entre d'une part le Luxembourge et la France, et d'autre part la Belgique, peuvent provoquer une double imposition.

*Me de Longueville (Belgique)* signale qu'il faut distinguer entre:

1° les doubles impositions d'ordre économique;
2° les doubles impositions d'ordre juridique, qui, seules sont reconnues.

En Belgique, on ne reconnaît pas les fictions juridiques françaises, et en France les fictions légales belges ne sont pas reconnues. La conclusion est qu'il faut qu'une double imposition économique soit juridiquement évitée.

*Me Goldsmith (France)* estime que puisqu'il est impossible de modifier la législation nationale, la solution consiste à se réferer aux dispositions légales du pays de la source et qu'en conséquence, le pays du bénéficiaire doit modifier ses propres concepts.

*En ce qui concerne les "associations en participation"*, la convention franco-belge prévoit dans son article 4, 2 qu'elles " . . . ne sont imposables que dans l'état contractant ou l'entreprise en question possède un établissement stable . . . ".

Quid si cette association en participation possède un établissement stable dans chaque pays?

S'il y a deux établissements stables, l'entreprise française pourrait être imposée en Belgique et l'entreprise belge en France. La retenue sur l'établissement stable s'appliquera. On ne pourrait considérer que l'établissement français reçoit le revenu français et l'établissement belge le revenu belge. Ce n'est pas conforme au texte.

*M. Kerlan (Administration française)* confirme que:
— chaque établissement est imposé uniquement dans le pays du lieu où il est fixé;
— il n'y a pas de compensation des pertes.

*Me de Longueville (Belgique)* relève que chaque établissement stable est imposé selon la conception économique et qu'ainsi est appliqué un principe de bon sens.

N.B. un intervenant (France) signale que selon ses renseignements la réponse "Baugitte" qui prévoit un régime favorable pour les caisses de pensions n'est pas étendu automatiquement aux caisses de retraites étrangères.
Dans le cas des relations franço-belges, la restitution de l'avoir fiscal est limitée aux personnes physiques. Dans le cas des relations entre la France et la Grande-Bretagne, le remboursesement de l'avoir fiscal a été étendu aux fonds de retraite.

## II. DOMICILE FISCAL

Cette notion n'a pas soulevé de problèmes.

## III. ETABLISSEMENTS STABLES

*Me Hoss (Luxembourg)* signale que la notion de "chantier de montage" pose des problèmes quant à la notion de l'origine des bénéfices:

1° le bénéfice réalisé par le montage sensu stricto;
2° le bénéfice issu des fournitures.

Le problème se poserait notamment avec l'Allemagne à propos de la construction de centrales nucléaires.

*M. Kerlan (administration française)* se déclare surpris que ce problème paraisse se poser entre pays de l'O.C.D.E. Selon lui, si une entreprise ne dispose d'aucune installation dans un pays où elle va être amenée à livrer une "usine clef en mains" les travaux de recherches seront réalisés par le siège de l'entreprise; ensuite commencera la phase de "l'installation". Dès lors, l'article 7 ne peut poser de question, le bénéfice des établissements stables sont limités aux opérations effectivement réalisées. Il s'agit d'une analyse stricte.

*M. Cooremans (administration belge)* marque son plein accord sur la position de Monsieur Kerlan.

Qu'en est-il lorsqu'une entreprise dispose dans des endroits différents ou à des moments différents de chantiers?

En ce qui concerne la Belgique, la réponse est donnée par le "Commentaire général des conventions préventives de la double imposition, chapitre V" qui prévoit, qu'en principe, il n'y a pas de cumul si les commettants sont distincts; l'adminstration considèrera que les travaux ne forment pas un tout, sauf, s'il en est économiquement ainsi (par exemple, en ce qui concerne les travaux exécutés dans un immeuble à appartements). Des travaux différents exécutés pour le compte d'un même commettant seront à prendre en considération globalement s'ils font l'objet d'un seul contrat. Encore est-il que si les travaux exécutés sont relatifs à des contrats différents, l'adminstration pourrait soutenir qu'il y a "une unité" en raison du facteur temps ou du facteur espace (cfr. Bulletin des contributions directes 1975, p. 31 et 32, 5/216).

*Me Goldsmith (France)* critique le dernier alinéa de l' article 4, 5 de la convention franco-belge qui prévoit qu'en cas de réunion de plusieurs des cas énumérés dans la convention comme étant non constitutifs d'établissement stable, l'autorité compétente des deux Etats se concertent pour déterminer si cette situation n'est pas nature à caractériser l'existence d'un établissement stable.

*Me de Longueville (Belgique)* souligne que la notion même d'établissement stable implique un "ensemble productif." La difficulté de cerner cette notion n'est pas contestable et explique la rédaction de l'alinéa critiqué. L'absence de cette disposition pourrait, par contre, présenter un danger car dans ce cas il ne serait pas dit par la convention qu'il y a établissement stable dans l'un ou l'autre pays et il y aurait risque que les deux administrations soutiennent des thèses divergentes. Et de conclure par la boutade: "dans le doute, l'administration ne s' abstient pas".

*M. Cooremans (administration belge)* signale que la convention franco-belge est périmée sur ce point et sera revue dans l'esprit de la convention modèle 1977. Les auteurs de la convention n'ont pas visé le "simple cumul". Sur le plan des faits, l'administration veillera toujours au caractère "auxiliaire" ou non de l'ensemble de l'activité déployée.

*M.J. Autenne (Belgique)* pose le problème de la retenue du précompte professionnel en raison du versement de salaire pour des ouvriers étrangers.

Selon la jurisprudence de la Cour de Cassation, si l'activité du personnel s'est exercée en Belgique et si leur rémunération est supportée par l'établissement stable fixé en Belgique, cela ne justifie pas ipso facto la retenue du précompte professionnel; encore faut-il qu'il y ait eu "paiement" c'est-à-dire la mise de revenu à la disposition du personnel en Belgique (Cour de cassation, 28 février 1974, en cause S.A. Droit français La Cellulose d'Aquitaine, Revue fiscale 1974, p. 42).

*Me de Longueville* rappelle que ce régime de retenue n'est pas le même pour les retenues sociales et pour les retenues fiscales.

*Me Van Fraeyenhoven ajoute:*
En ce qui concerne le précompte professionnel, il y a lieu également de remarquer que si la rémunération est versée à l'étranger, mais que le personnel bénéficie d'un avantage en nature en Belgique, cet avantage en nature peut donner lieu à ouverture au précompte professionnel (Cour d'appel de Liège, 13 décembre 1971, Revue fiscale 1972, p. 315; Cour d'appel de Bruxelles, 12 mai 1975, Journal de droit fiscal 1975, p. 124).

Quant à la détermination des bénéfices des établissements stables:

*M. Cooremans, (administration belge)* signale que conformément à la loi interne les principes généraux applicables en matière de détermination des bénéfices d'une entreprise doivent être retenus et qu'éventuellement, il peut être fait recours à la procédure amiable prévue à l'article 25, 2 de la convention modèle O.C.D.E. En ce qui concerne la procédure amiable, encore faut-il qu'il y ait eu une demande qui soit postérieure à l'enrôlement d'une cotisation contestée.

En ce qui concerne les rapports franco-belges, Monsieur Cooremans signale que les administrations tentent de trouver un "commun dénominateur".

*Me Goldsmith* fait remarquer que dans le cas de taxations forfaitaires basées sur les frais généraux, des difficultés peuvent survenir quand l'administration de l'autre pays n'est pas d'accord sur le même forfait.

## IV. REVENU IMMOBILIER

La complexité de la question des revenus immobiliers est liée aux caractéristiques particulières que revêtent certaines sociétés immobilières françaises. Les sociétés françaises qualifiées de "transparentes" existent juridiquement. Toutefois, des différentes interventions il ressort que:

- bien qu'elles soient propriétaires des biens, elles ne peuvent vendre elles-mêmes les immeubles;
- elles ne peuvent que remettre la jouissance ou la propriété des immeubles aux associés, mais ne bénéficient pas des revenus de ces immeubles.

 

Fiscalement ces sociétés "transparentes" n'existent pas au plan fiscal. Chacun des associés de ces sociétés est imposé dans son propre chef.

En Belgique ces revenus deviennent normalement mobiliers.

Cette discordance aboutissait à un phénomène de double imposition et ce particulièrement en cas de plus-value.

Me de Longueville demande d'appliquer dans ce cas la fiction française ou mieux la règle fiscale française qui correspond à la loi applicable aux revenus immobiliers.

*Monsieur Cooremans (administration belge)* marque son accord sur l'avis émis par Me de Longueville, mais insiste sur le fait que son administration est liée par le droit interne belge.

Il faut signaler qu'une circulaire récente du 15 mars 1978 (N Ci. R. 9. F/6 e addendum à la circulaire 920, Bulletin des contributions 1978, p. 673) prévoit en ce qui concerne les plus-values recueillies par des résidents de la Belgique et provenant de la cession de droits sociaux dans les sociétés immobilières françaises que:

> "quant aux plus-values obtenues à l'occasion de la réalisation des droits précités, elles sont imposables exclusivement en France conformément à la législation de ce pays (art. 3, § 1, § 2 et § 4, 2 e phrase, convention). Dans la mesure où la législation interne belge prévoit l'imposition de tels revenus dans le chef de résidents, la Belgique est tenue d'accorder l'exemption sur base de l'article 19, A, § 2, convention, mais elle peut prendre ces revenus en considération pour fixer *le taux* applicable aux autres revenus imposables des bénéficiaires belges (art. 19, A, 3$ 4, convention)."

## V. DIVIDENDES

En ce qui concerne l'avoir fiscal français, diverses questions furent posées sans obtenir de réponse satisfaisant l'interlocuteur:

— pourquoi refuse-t-on .'avoir fiscal aux sociétés méres étrangères possédant plus de 25
— pourquoi refuse-t-on l'avoir fiscal aux sociétés mères étrangères possédant plus de 25% des titres?
— est-il justifié de veiller à ce que les dividendes arrivent chez certains actionnaires?
— si oui, quel contrôle convient-il d'organiser?

La non-extension de l'avoir fiscal ne va-t-elle pas à l'encontre du Traité de Rome.

*Me Goldsmith*
Le remboursement de l'avoir fiscal est refusé aux sociétés-mères qui détiennent plus de 25 pour cent des actions d'une filiale. La convention franco-belge le refuse aux sociétés. Une personne physique est donc dans une situation différente selon qu'elle est actionnaire d'une société française ou de la société-mère de cette société. Lors de la revision de la convention franco-belge, il faudrait en revenir au droit commun des conventions: refus du remboursement de l'avoir fiscal seulement si la société-mère détient 25 pour cent des actions de la filiale.

*M. Kerlan*
La France a accordé le bénéfice de l'avoir fiscal aux revenus de portefeuilles et aux revenus tirés de sociétés ne dépassant pas un certain taux de participation (Suisse: 20 pour cent, parfois 10 pour cent, Luxembourg: renvoi au droit interne: dividendes effectivement soumis à l'impôt luxembourgeois).

La France considère que les sociétés-mères sont soumises à des contraintes de redistribution. Cette règle n'est pas contrôlable dans le chef des sociétés-mères étrangères. On peut craindre l'accumulation de bénéfices dans des sociétés holdings, ne donnant pas lieu à imposition dans le chef de personnes physiques.

La Grande-Bretagne accorde le crédit i'impôt aux sociétés-mères américaines, mais non aux sociétés-mères françaises.

L'Allemagne a adopté le système du crédit d'impôt, mais les sociétés-mères françaises ne peuvent en bénéficier, pas davantage d'ailleurs que les personnes physiques françaises.

La directive de la C.E.E. relative au crédit d'impôt européen a été mise en échec devant le Parlement européen.

*Me Goldsmith*
Le commentaire de l'O.C.D.E. souligne, sous l'article 10, que l'octroi du crédit d'impôt entre sociétés vise à éviter les cascades d'imposition. Est-il justifié dans ce cadre de se préoccuper de la redistribution? Dans l'affirmative, ne peut-on trouver un système de contrôle?

*M. Kerlan*
L'administration désire que le bénéficiaire du revenu soit imposé. Il est souhaitable que les investissements en France se fassent sous forme d'investissement de portefeuille plutôt que sous forme de création de filiales échappant au contrôle français. L'avoir fiscal français et l'avoir fiscal britannique sont étendus aux personnes physiques et aux sociétés ayant une participation inférieure à 10 pour cent. L'avoir fiscal français est accordé aux Allemands, sans concession de la part de l'Allemagne.

*M. Cooremans*
Les Allemands ont demandé à la Belgique d'accorder le crédit d'impôt aux résidents allemands. La Belgique ne peut l'accepter parce que le crédit d'impôt belge est différent des autres: il s'agit d'un allègement forfaitaire au niveau de l'actionnaire, applicable même si l'impôt des sociétés n'a pas été percu. L'Allemagne pratique le double taux (56-36 pour cent), en raison duquel elle peut percevoir une retenue à la source de 25 pour cent. L'Allemagne a changé de système, mais maintient la différence à 20 points pour maintenir l'application des conventions internationales. La Belgique attend que l'Allemagne négocie d'abord avec les Etats-Unis. En Grande Bretagne, le gouvernement reconsidère l'extension de l'A.C.T. au-delà des frontières. Elle offre l'A.C.T. à la Hollande alors que celle-ci ne propose pas la réciproque. La Grande Bretagne veut inciter à investir dans les sociétés britanniques.

## VI. INTERETS

*Me Hoss (Luxembourg)* signale que la convention franco-luxembourgeoise de 1958 supprimait toute retenue dans le pays de la source. Suite aux modifications intervenues par l'avenant du 8 septembre 1970, il fut prévu que L'Etat de la source garderait le droit de prélever une retenue résiduaire de 10 pour cent. Toutefois, le Luxembourg ne connait une retenue d'impôt sur intérêts qu'en ce qui concerne les obligations et cette retenue est limitée à 5 pour cent.

Le bénéficiaire luxembourgeois des intérêts jouit d'un crédit d'impôt pour l'impôt français retenu à la source, mais ce crédit d'impôt est limité au montant de l'impôt luxembourgeois dont il est redevable au Luxembourg du chef des mêmes intérêts.

Or, l'impôt luxembourgeois est calculé sur le bénéfice net des opérations financières, càd. après la prise en considération non seulement du coût du refinancement, mais encore des frais administratifs propres à chaques opérations considérées individuellement. Dès lors, le plus généralement, le contribuable luxembourgeois ne bénéficie pas en pratique de la totalité de son crédit d'impôt.

## VII. DEDUCTIBILITE DES INTERETS

Le législateur belge a prévu une limitation quant à la déductibilité des intérêts payés aux banques.

Sont déductibles les intérêts dont le taux correspond à celui pratiqué par la banque nationale majoré de 3 pour cent ou à 9 pour cent maximum lorsque le taux pratiqué par la Banque Nationale est inférieur à 6 pour cent. Lorsque les taux d'intérêt sont supérieurs à ces maxima, seuls les intérêts payés à des banques belges ou à des établissements belges de banques étrangères sont déductibles.

L'article 50 du Code des impôts sur les revenus qui prèvoit cette limite de déduction n'est-il pas contraire au Traité de Rome et plus particulièrement à son article 67?

*M. Cooremans* (administration belge) estime qu'aucun texte n'interdit cette discrimination. Dans la nouvelle convention cette distorsion sera supprimée (cfr. art. 24, § 5 de la convention modèle).

Un intervenant signale que cet article 67 ne serait pas "self-executing".

### Emprunt contracté pour les besoins d'un établissement stable

*Monsieur Cooremans* (administration belge) signale que la convention modèle traite de la question à l'article 11, § 5, qui prévoit qu'en cas d'emprunt contracté au profit d'un établissement stable et qui donne lieu au paiement d'intérêts dont la charge est supportée par l'etablissement, ces intérêts sont considérés comme provenant de l'Etat où l' établissement stable est situé.

# Summaries*

*A common study meeting of the France and Belgium/Luxembourg I.F.A. groups recently dealt with the following subject:*

*"Do the France-Luxembourg and France-Belgium tax conventions meet current needs as regards the avoidance of double taxation"?*

*The observations of the Luxembourg section of the Belgium/Luxembourg I.F.A. group on certain points of the France-Luxembourg Tax Convention were published in Bulletin No. 9/1978 p. 470.*

*The observations of the French group of I.F.A. and the Belgian section of the Belgium/Luxembourg group and the report of the debates are outlined below.*

* The summaries were made by the Editors of the Bulletin who are solely responsible for their contents.

## Summary of the paper prepared by Mr. J.C. Goldsmith for the French delegation

### 1. Definition of permanent establishment

*Both the Belgian-French and the Luxembourg-French tax treaties provided that a person acting in one of the countries on behalf of an enterprise of the other country shall be deemed to be a permanent establishment if he has and habitually exercises an authority to conclude contracts in the name of the enterprise. An agent who habitually draws on stocks of goods or merchandise belonging to the enterprise for sale or delivery to clients will be regarded as exercising such authority. This latter assumption is now outdated and it may result in double taxation, especially with respect to French legislation.*

*Art. 4(5) of the Belgian-French tax treaty provides that where several cases mentioned in this article which are expressly listed as* not *constituting a permanent establishment occur simultaneously, the Belgian and French tax administrations will consult each other to determine whether in fact a permanent establishment exists. This provision seems to be rather contradictory with respect to other provisions of Art. 4.*

### 2. Tax treatment of parent and subsidiary companies

*The general rule is that dividends can flow from a subsidiary company through its parent to the shareholder without attracting much more tax than if the shareholder had directly participated in the subsidiary. This situation does not exist where the parent corporation is either established in Belgium or Luxembourg, and the subidiary in France.*

*Individual shareholders resident in Belgium or Luxembourg may with respect to dividends received from a French corporation benefit from the "avoir fiscal" (i.e. a refund of 50 percent of the French corporate income tax) whereas if they receive such a dividend through a Belgian or Luxembourg parent the benefit of the "avoir fiscal" will be lost.*

**3. Additional taxation of permanent establishments**

*Under French income tax law permanent establishments of non-resident corporations are generally subject to a 12.5 percent income tax which is imposed in lieu of the withholding tax which applies to dividends distributed by French corporations to non-resident shareholders. This additional imposition on permanent establishments has been retained under the Belgian-French and French-Luxembourg tax treaties, although in the case of permanent establishments of Belgian and Luxembourg corporations this rate has been reduced to 5 percent. Such taxation distorts international fiscal neutrality.*

**4. Withholding tax on dividends distributed by subsidiary companies**

*Most tax treaties concluded by French reduce the rate of withholding tax on dividends distributed by a French subsidiary corporation to a non-resident parent to 5 percent provided the non-resident parent owns at least 25 percent of the capital of the French subsidiary. However, in the case of the Belgian-French tax treaty the rate of French withholding tax is only reduced to 10 percent (in case the Belgian parent owns at least 10 percent of the capital of the French subsidiary).*

*Belgian corporate income tax does not provide for a credit or other relief with respect to foreign withholding tax on dividends received by a Belgian parent. Therefore, the net amount received by the Belgian individual shareholder from the Belgian parent is a function of these withholding taxes and varies according to the country in which the subsidiary is established.*

**5. Problems connected with interest**

**a. Loan contracted in Belgium by the French permanent establishment of a Belgian corporation**

*The French tax administration imposed a 15 percent tax (reduced rate provided for in Belgian-French tax treaty) on the interest payments by the permanent establishment to Belgian banks. However, the Belgian tax administration protested since it found that the source of the interest was located in Belgium so that France did not have the right to tax the interest.*

**b. Loan contracted by a French enterprise with a Luxembourg bank**

*France imposes a withholding tax at the reduced rate of 10 percent on such interest. The Luxembourg bank may in principle credit this tax against the Luxembourg corporate income tax computed on the* net *amount of the interest, i.e. after deduction of expenses attributed to such interest. In practice the taxable interest often is reduced so much that the withholding tax cannot be fully credited. Thus double taxation occurs.*

*In those cases where the French withholding tax cannot be fully credited the remaining amount cannot be deducted as an expense, hardly an equitable result.*

**6. Duration of construction or assembly projects**

*The Belgian-French and French-Luxembourg tax treaties consider a construction or assembly project whose duration exceeds 6 months to be a permanent establishment. However, an enterprise may have at the same time several construction projects in Belgium at different locations and for different clients. The Belgian tax administration in determining whether construction projects constitute a permanent establishment tends to aggregate the duration of these various construction projects, often causing problems.*

**7. Problems connected with joint ventures between French and Belgian enterprises**

*These problems mainly revolve around the fact that France imposes an additional tax on profits derived through a permanent establishment located in France of the Belgian enterprise and that France does not allow compensation for foreign profits (if derived through a permanent establishment) and losses incurred in France (and vice versa).*

**8. Royalties**

*Both treaties provide that royalties are only taxable in the country where the lessor resides, which conforms to the normal rule in such cases.*
*However, any excessive amounts paid in a not at arm's-length situation will be treated as dividends or as other income covered by the treaty. It seems that the French-Belgian tax treaty permits double taxation in such cases.*

**9. Luxembourg holding companies**

*Luxembourg holding companies are excluded from the benefits of the French-Luxembourg tax treaty. This may cause a problem where the French bank paying the dividend is not quite certain whether the recipient is a holding company or not. If it is a holding company it will not be entitled to the "avoir fiscal" whereas if it is not it may claim the "avoir fiscal", provided it is not a parent of the distributing corporation.*

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## Summary of the paper prepared by Messrs. André Buelinckx, Henry Levy-Morelle and Guy van Fraeyenhoven for the Belgian delegation. The co-ordinating work was done by Mr. Jean de Longueville

**1. Tax position of Belgian partners of certain French entities which are disregarded for purposes of French corporate income tax**

*Certain French partnerships which own and manage real property — so-called "sociétés civiles immobilières" (SCI) — are disregarded for corporated income tax purposes although they are considered to be legal entities for purposes of civil law. They are not subject to corporate income tax, but their partners are directly assessed individual income tax for the income derived through an SCI whether distributed or not. Such income is deemed to be income from real property. When the income is distributed by the SCI no further assessment in France is made.*

*Under Belgian income tax law, however, commercial entities are generally subject to corporate income tax, unless certain conditions have been fulfilled and the members or associates of these entities have expressly requested the entity be exempt from corporate income tax.*

*In addition, Belgian income tax law does not recognize the fictions used by foreign income tax law, unless such fictions have expressly been recognized under a tax treaty.*

*The result is that income retained by French SCIs is not considered under Belgian income tax law to be income of its partners. However, when such income is distributed Belgian income tax law deems it to be dividends subject to income tax in the hands of the partners (a fixed credit of 15 percent representing foreign income or withholding tax applies). Thus, in spite of the tax treaty double taxation occurs.*

*The logical solution is that the Belgian-French tax treaty should deem such income of SCIs to be real property income which would be subject to taxation exclusively in France. Currently, the abovementioned treaty expressly retains this tax scheme. The Belgian delegation, therefore, advocates amendment of the treaty.*

**2. Taxation of real property capital gains**

*Under both Belgian and French income tax law certain real property capital gains are subject to individual income tax, especially those derived from the sale of unimproved real property. Such capital gains are under Art. 3(4) of the Belgian-French tax treaty subject to taxation in the country where the property is located.*

*A problem arises since French income tax law deems an interest in or shares in real property companies to be real property and consequently any capital gains derived from the disposal of such interest or shares to be real property income subject to income tax in the situs country. However, the Belgian tax administration considers any gains derived through the sale of such interest or shares to be personal property income which is subject to income tax in the country where the owner of the interests or shares resides. Since double taxation of such capital gains might occur the Belgian delegation advocates that they be deemed real property capital gains whenever it would be possible to amend the Belgian-French tax treaty.*

**3. Discrimination in the case of deductibility of interest**

*Under Belgian income tax law, businesses may in principle deduct interest on loans taken for business purposes up to a certain maximum rate (the rate which is charged by the National Belgian Bank on certain loans plus 3 percentage points or 9 percent if the latter rate is higher). However, as of 1974 no such limit applies to interest paid to Belgian banks or to Belgian branch offices of foreign banks.*

*The Belgian income tax thus discriminates against interest payments made to banks situated abroad, notably in France and in Luxembourg and also violates Art. 67 of the Rome Treaty. It further creates an economic double taxation (i.e. double taxation of the same income with two different taxpayers) since the foreign bank will be subject to income tax on the full amount of interest received, whereas the Belgian taxpayer — in those cases where interest in excess of the limit is paid — may only deduct part of the interest. The Belgian delegation, therefore, advocates abolition of the limit on the deduction of interest and denial of the deduction only in those cases where the interest is truly excessive.*

**4. The granting of the French "avoir fiscal" to Belgian corporate shareholders**

*Under the French imputation system of corporate and shareholder taxation one half of the corporate income is refunded to the shareholder with respect to the dividends he receives in the form of a tax credit. This credit — "avoir fiscal" — is granted to resident individual and corporate shareholders and is usually taken as a credit against the income tax liability. If the "avoir fiscal" is in excess of the income tax liability individual shareholders will receive a refund. No such refund, however, is available to corporate shareholders. The "avoir fiscal" is not granted to non-resident shareholders unless a tax treaty provides so.*

*Under the provisions of the Belgian-French tax treaty the French "avoir fiscal" is only granted to Belgian individual shareholders of French corporations. Belgian corporate shareholders are excluded because under former Belgian income tax law, Belgian corporations were generally exempt from corporate income tax. However, under present Belgian law only dividends received with respect to so-called permanent participations are exempt (in general a permanent participation exists where the Belgian corporate shareholder has held the shares during the entire fiscal year) and dividends received on non-permanent participation are subject to the full rate of Belgian corporate income tax.*
*A similar situation exists with liquidation distributions which are treated by French income tax law as dividends and by Belgian law as capital gains on invested capital (see also infra).*

*The Belgian delegation advocates to remedy this situation.*

**5. Taxation of permanent establishments**

*The following anomalies exist:*

a. *If a Belgian company has a permanent establishment (branch office) in France and if it holds through this French permanent establishment a participation (shares) in a French subsidiary company it will be subject to double taxation with respect to the dividends received, i.e. (i) the income from which the dividend was paid is taxed to the French corporation and (ii) the dividend itself is fully taxable as income of the permanent establishment. The affiliation privilege which is accorded dividends received by a French parent corporation does not apply in this case.*
*Note that in the opposite situation, i.e. where a French parent holds a participation in a Belgian subsidiary corporation through a Belgian permanent establishment no such discrimination occurs; the dividend exemption applies as if the dividends were paid to Belgian parent corporation.*

b. *In both Belgium and France the income derived by permanent establishments of a corporation situated in the other country is subject to higher income tax rates than those imposed on domestic corporations. In Belgium the rate of corporate income tax on French corporations is 50.6 percent instead of 48 percent as is the case for domestic corporations. France imposes an additional tax (5 percent) on the income of permanent establishments of Belgian corporations in lieu of the withholding tax which would have applied to dividends distributed by a subsidiary company of the Belgian parent. Belgium does not impose such an additional tax on permanent establishment income of non-resident corporations but contents itself with a higher rate of corporate income tax (see supra).*

*The Belgian delegation advocates removal of this additional French tax and reduction of the Belgian rate of corporate income tax to 48 percent by amendment of the tax treaty.*

**6. The granting of the Belgian special credit to French shareholders**

*Under the Belgian imputation system, double taxation of distributed corporate income is mitigated in the following manner:*

- *if the shareholder is a corporation it may credit the withholding tax (20 percent) on the dividend against the corporate income tax due; in the case the withholding tax exceeds the corporate income tax liability a refund is available. In addition 95 percent of the dividend is exempt from corporate income tax, unless the parent corporation is a holding company, in which case the exemption is reduced to 90 percent of the dividend received.*
- *if the shareholder is an individual person the withholding tax may also be credited against the taxpayer's income tax liability or is refunded. The taxpayer receives an additional special*

*credit (approximately one-half of the rate of corporate income tax) which is not refundable should it exceed the taxpayer's tax liability. The dividend must be grossed up by the amount of the withholding tax and the special credit.*

*French shareholders of Belgian corporations are entitled to a reduction of the withholding tax (from 20 to 15 percent). This reduced withholding tax may be credited against the French income tax. In this respect no problems exist. However, Belgium does not accord non-resident shareholders the special credit, which considering the heavy taxation in Belgium and France may lead to an effective tax rate of close to 100 percent in some cases.*

*The Belgian delegation advocates amendment of the the Belgian-French tax treaty in such manner that French shareholders of Belgian corporations may benefit from the Belgian special credit (provided, of course, that there is reciprocity).*

### 7. Tax treatment of the liquidation of Belgian and French corporations

*Corporate liquidations may also result in double taxation for which the Belgian-French tax treaty does not have an adequate solution. This double taxation is essentially caused by the fact that liquidation distributions are in France considered to be a dividend distribution subjec to tax in the hands of the shareholders and in Belgium as capital gains, subject to an additional corporate income tax with the distributing company.*

*The Belgian delegation suggests that this situation be remedied.*

## Summary of the report on the debates. The notes were made by Messrs. J.P. Nemery de Bellevaux, M. Cozian, J. Malherbe and J. Autenne.

### General discussion

*It was agreed that the discussions should follow the outline of the OECD Model Convention. Mr. Kerlan (representative of the French tax administration) remarked that the negotiations for the conclusion of the Luxembourg-French and the Belgian-French tax treaties were held at a time when the new policy regarding international taxation was only just being formulated.*

### I. Persons concerned

*Although the reports submitted did not indicate any problems regarding "persons concerned" (i.e., persons to which the treaties apply) in tax treaties there was much debate on this subject, mainly because of problems resulting from French legislation.*

*Article 3(1)(b) of the Model Convention states that: "the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes".*

Question: *What is the situation with respect to so-called "sociétés de personnes" (SPs)?*

*In* Belgium *SPs are legal entities which are subject to corporate income tax but which may under certain conditions elect to be exempt from this tax in which case the partners or associates will be directly assessed income tax on any distributed or retained profits of the SP.*

*In* Luxembourg *SPs are not subject to corporate income tax. Instead, their partners are subject to income tax and business tax on the distributed and retained profits.*

*In* France *the general partnership and the limited partnership are legal entities. These entities are in principle not subject to corporate income tax and their partners — as are the partners of certain joint ventures designated as "associations en participation" — are subject to income tax on the distributed and retained profits of such entities. However, they may under certain conditions elect to be treated as corporations.*

*In France a special legal form exists — the "Groupement d'intérêt économique" or G.I.E. — which is used by businesses to further common interests, e.g. two corporations decided to co-operate in a research project. The G.I.E. is a legal entity but for tax purposes it is not considered to be a separate taxpayer. Instead its results are directly attributed to its partners.*

*These different concepts of business entities may result in double taxation, whether "juridical" (i.e. a taxpayer is taxed twice on a certain part of his income) or "economic" (i.e. the same income is taxed twice although the taxpayers differ). Another source of double taxation is that the countries do not recognize certain legal fictions which are used in another country.*

### II. Fiscal domicile

*This term did not cause any problems.*

### III. Permanent establishment

*Mr. Hoss (Luxembourg) indicated that the concept of "construction or assembly project" causes certain problems with respect to the origin of the profit made:*
1. *the profit may be derived from the construction itself; or*
2. *the profit may be made on the supply of material.*

*This is currently an acute problem in the construction of nuclear energy plants in the Federal Republic of Germany.*

*Both Mr. Kerlan (French tax administration) and Mr. Cooremans (Belgian tax administration) were of the opinion that only the profit connected with the construction or assembly activities can be subject to tax in the country where these operations are carried on.*

*The question was also raised as to what the consequences are if an enterprise is engaged in construction projects in different places or at different times. The Belgian tax administration has issued a ruling on this subject.*

*Mr. Goldsmith (France) criticised Article 4(5) of the Belgian-French tax treaty wherein it states that in case there exist a number of facts which individually do not constititute a permanent establishment, they may together constitute such an establishment. Whether a permanent establishment exists is decided by the two tax administrations after consultation. Mr. De. Longueville (Belgium) explained that the absence of such a phrase might result in problems if the opinions of the tax administrations differed. Mr. Cooremans (Belgian tax administration) stated that the Belgian-French tax treaty is obsolete on this point.*

1. Sps include general and limited partnerships and in Belgium also a type of limited liability company.

*Mr. J. Autenne (Belgium) raised the problem of the withholding of Belgian income tax on salaries of foreign workers. Even if they work in Belgium and if the salaries are charged to a permanent establishment located in Belgium this does not necessarily mean that withholding tax must be deducted. Only where the effective payment is made in Belgium need the tax be withheld.*

*Mr. Cooremans (Belgium) remarked that the profit of a permanent establishment will be determined according to the rules of national law and that if necessary the two tax administrations can get together under the mutual agreement procedure prescribed in the tax treaty. It has always been the practice in Belgo-French relationships to attempt to find some "common denominator."*

*Mr. Goldsmith (France) remarked that especially in the case where lump sum deductions are granted there may be a difference of opinion between the two tax administrations.*

## IV. Real property income

*The complexity of the problems connected with real property income is mainly caused by the special characteristics of French real property companies, which are deemed to be "transparent", i.e. they are not subject to income tax, whereas the interest or the shares held by their associates are treated as real property for income tax purposes. In Belgium, however, such property is considered to be personal property and this may cause double taxation.*

## V. Dividends

*A number of questions were posed with respect to the French "avoir fiscal" such as:*

1. *Why is the "avoir fiscal" refused to non-resident holding companies owning more than 25 percent of the capital of domestic subsidiaries?*
2. *Is it justifiable to see to it that the dividends are received by certain shareholders?*
3. *If so, how must this be controlled?*

*More generally: Does the non-availability of the "avoir fiscal" violate the Rome Treaty?*

*Mr. Goldsmith (France): The refund of the "avoir fiscal" is refused to [non-resident] parent companies which hold more than 25 percent of the capital of the [French] subsidiary. The Belgian-French tax treaty refuses the "avoir fiscal" to* all *Belgian corporate shareholders. An individual shareholder is, therefore, treated differently when he directly holds shares in a French corporation than when he holds shares in the Belgian parent company of such company.*

*Mr. Kerlan (French tax administration): France has accorded under certain tax treaties the benefit of the "avoir fiscal" to foreign shareholders with respect to portfolio investment and with respect to shares held by corporate shareholders whose participation does not exceed a certain percentage of their subsidiary's capital. The French authorities consider that French parent corporations are put under pressure with respect to the redistribution of the dividends they have received. However, it will be difficult to ascertain whether this is the case with a nonresident parent corporation. It may be feared that foreign holding companies would accumulate dividend income without passing it on to their shareholders. It is noted that the United Kingdom accords the credit under its imputation system to United States parent corporations, but not to French parents. Germany has also adopted the imputation system, but neither French parent companies nor individual persons resident in France can benefit from the credit which is accorded under this system.*

*It was also noted that the EC Directive on the corporate and shareholder taxation has been rejected by the European Parliament.*

*Mr. Goldsmith (France): The commentary to Article 10 of the OECD Model Convention states that the granting of a credit under an imputation system is meant to mitigate double taxation. Is it then justified to worry about the redistribution of dividends and, if so, could one not design some control system?*

*Mr. Kerlan (French tax administration): The tax administration wishes to impose tax on the recipient of the income. It considers it desirable that investment in France take place in the form of portfolio investment rather than in the form of the creation of subsidiary companies which are difficult to control by the French tax authorities. Therefore, the French "avoir fiscal" as well as the British credit are granted to individual shareholders and corporate shareholders who have a participation of less than 10 percent. [This statement refers to the French-British tax treaty]. France accords the "avoir fiscal" to German shareholders without receiving any reciprocal any concessions from Germany.*

*Mr. Cooremans: The German authorities have asked Belgium to accord the credit under its imputation system to residents of Germany. However, Belgium cannot comply with this request since the Belgian credit differs from the credit granted under other imputation systems: it is a fixed tax relief which is granted at the shareholder level and which is even available in those cases where no corporate income tax has been levied. Germany applies a split rate (36-56 percent) of corporate income tax so that it can apply a 25 percent withholding tax rate on dividends. For this purpose it has deliberately maintained the 20 percentage point difference between the higher and the lower rate which has been prescribed in tax treaties of Germany to permit the use of the 25 percent withholding tax on dividends. Belgium will await the results of the German-United States negotiations. In the United Kingdom the Government is reconsidering the extension of the ACT system across the frontiers. It has offered the ACT to the Netherlands although the Netherlands has not granted anything in return. Apparently, the United Kingdom wishes to attract foreign investment in British companies.*

## VI. Interest

*Mr. Hoss (Luxembourg) stated that under the present French-Luxembourg tax treaty each of the countries may levy a 10 percent withholding tax on interest paid to a creditor established in the other country. However, Luxembourg normally does not impose a withholding tax on interest except for a 5 percent withholding tax on bond interest.*

*The Luxembourg recipient of interest income may credit the French withholding tax against the income tax assessed on the interest. However, the credit is limited to the amount of income tax which can be attributed to the interest. However, the Luxembourg income tax is levied on the* net *interest so that in many cases the attributable part of the income tax is less than the amount of credit to which the recipient is entitled, thus part of the credit is lost.*

## VII. Deductibility of interest

*Interest on loans contracted for business purposes is only deductible to a certain maximum which is related to the rate of interest given by the Belgian National Bank on certain loans. However, interest paid to Belgian banks and Belgian permanent establishments (branch offices) of foreign banks is fully deductible. Mr. Cooremans does not think there are provisions — including those of the Rome Treaty — which forbid such a discrimination. However, in new tax treaties this discrimination will be removed.*

*He also stated that under the provisions of the 1977 OECD Model Convention, interest on a loan contracted for a foreign permanent establishment of an enterprise is considered to be derived from a source located within the country where the permanent establishment is situated.*

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# Bibliography

# Books

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

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# cumulative index 1 ~ 10

# Contents

of the December 1978 issue



**In next issues:**

Compensation of expatriates transferred to Brazil
— by *Aleksas Juocys*

Malaysia: The Real Property Gains Tax Act 1978
— by *C.S. Yeoh*

Tax reform in India: an evaluation of the Report of the Indirect Taxation Enquiry Committee
— by *G. Thimmaiah*

Puerto Rico: the new tax exemption law
— by *Arthur J. Mann*

U.S.A.: The Foreign Earned Income Act of 1978; the taxation of U.S. citizens overseas
— by *Richard P. Casna*

German Democratic Republic: The promotion of house construction in GDR towns and communities by the State financial system
— by *Prof. Hans Spiller*

Brazilian legislation on industrial development
— by *Antonio Mendes*

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

# Overseas Investment in Australian Oil and Gas

By R.E. BLANCKENSEE, LL.B.

**(Laws Relating to Investment in Australia; Ways in which Non-Residents Can Conduct their Operations There; Taxation Implications Involved Therein, and Special Taxation Deductions Available.)** [1]

## INTRODUCTION

*In recent months there has appeared to be a renewed interest shown by overseas companies and individuals in certain types of investment in Australia. This is no doubt due partly to the development proposed in the north-west of Western Australia by a consortium which hopes to proceed with the development of a substantial off-shore gas project. A considerable amount of interest has also been shown by a number of overseas companies who have been given exploration permits for adjacent off-shore areas which are considered to hold substantial quantities of petroleum.*

*Those companies and individuals who are interested in establishing an Australian scene will need to consider a number of factors before they actually commence operations there. Although in general terms the Australian legal system is based on the English common law with local statutes, there are two forms of Government operating. Firstly, there is the Federal Government which legislates on certain matters applicable to the whole of Australia, such as trade, financial policy and foreign investment. In addition, there are six State Governments each of which legislates on matters which are not dealt with by the Federal Government, such as company law and industrial development.*

*As a result, it is necessary for a potential investor to have regard not only to the system of law administered by the Federal Government but also the laws of the States in which it is intended to operate.*

*It will be convenient to deal with the pertinent matters under the following headings:*

1. *What are the applicable laws relating to investment in Australia?*
2. *The ways in which non-residents can conduct their operations in Australia.*
3. *The taxation implications involved in the conduct of those operations.*
4. *Special deductions which are available for taxation purposes to persons who are involved in petroleum operations.*

CONTENTS



1. Based on a Paper presented in London in early 1978.

## 1. What are the laws relating to investment in Australia?

### A. FEDERAL AUTHORITIES

*(1) Foreign Investment Review Board*

In 1975 the Federal Government passed the Foreign Takeovers Act and set up a Foreign Investment Review Board. It is the duty of the Board to screen certain investments in Australia by foreign interests. It is Government policy to prevent foreign investment in banking, radio, television, newspapers and certain forms of aviation.

The Government has also determined that a foreign investor cannot hold more than a 25 percent interest in the production of uranium and, in addition, the uranium venture must be controlled by Australian residents.

Apart from these restrictions, a foreign investor who is proposing to acquire Australian assets, or to make investments in Australia, must submit his proposals to the Review Board.

The Foreign Takeovers Act lays down guidelines for determining what is a foreign investor for the purposes of the Act. A foreign investor is:

(a) a natural person who does not normally reside in Australia;
(b) a foreign resident who or which controls an Australian business or corporation;
(c) a foreign investor who owns 15 percent or more, or a number of foreign investors who together own 40 percent or more, of an Australian business or corporation, irrespective of who actually controls it.

There is deemed control by a foreign investor in cases where:

(i) a natural person who does not ordinarily reside in Australia, or a corporation incorporated outside Australia, holds an interest of 15 percent or more in the ownership or voting power of an Australian corporation; or
(ii) two or more natural persons not ordinarily resident in Australia, or corporations incorporated outside Australia, have aggregate interests of 40 percent or more in the ownership or voting power of the corporation.

It is, however, open to the foreign investor to prove to the Board that he or they do not in fact control the corporation.

The next step is to determine whether the particular proposal is one which is required to be submitted to the Board for its review. The following are the proposals which must be submitted to the Board:

(a) the acquisition of an interest in an Australian business or company where the acquisition would give the foreign investor or investors more than the percentage of shareholding referred to under (c) above;
(b) the acquisition of the assets of an Australian business;
(c) an increase in the representation of foreign investors on the Board of Directors of an Australian corporation;
(d) an arrangement conferring on a foreign investor the right to use the assets of an Australian business or to participate in the management or profits of an Australian business;
(e) the establishment of a new non-banking financial institution or an insurance company;
(f) the establishment of other new businesses, including mining, involving an investment of $1 million or more;
(g) an increase in the ownership of a foreign investor in an existing business where that interest is already substantial;
(h) certain real estate transactions.

Any proposed investments which are not listed in the above categories do not require the approval of the Foreign Investments' Board but may require Exchange Control approval.

In determining whether approval will be given to the foreign investment, the Board has regard as to whether the proposal is generally in the Australian interest. Certain guidelines have been laid down by the Government to enable the Review Board to arrive at its determination and, in many cases, these particular guidelines do overlap some of those mentioned above. However, in particular, the Board must consider the following matters:

(i) Is the investment controlled by Australian residents at the Board level and what is the percentage of Australian equity participation? In the latter respect, it is the desire of the Government to aim for not less than a 50 percent Australian equity. The Government recently modified the interpretation of this requirement so that in applying the 50 percent Australian ownership objective for new investment projects in the area of natural resources (other than uranium) a new concept of "naturalisation" of foreign companies was introduced. Under the new policy a company will be regarded as having achieved the status of at least 50 percent Australian share ownership and 50 percent Australian voting strength at Board of Directors meetings if it has:
   (a) minimum 25 percent Australian equity;
   (b) Articles of Association which provide for a majority of the Board of Directors to be Australian citizens; and
   (c) made a public commitment to increase Australian equity to 51 percent subject to understandings between the company, major shareholder interests and the Government; and to have regular discussions with the Foreign Investment Review Board on progress to achieve 51 percent Australian ownership.

   The Government's aim is to assist development of new projects by foreign companies which are already substantially Australian owned and which do not have, but are prepared to introduce, majority Australian ownership. There are no time limits and the Government has not said how it proposes to enforce undertakings made by companies. However, the Government has said that it expects the "naturalisation" powers to take place permanently by way of new share issues to Australians to find new projects and expansions rather than by takeovers which remain subject to examination under the Foreign Takeovers Act.

(ii) Is the proposed business for the economic benefit of Australia with respect to the following matters:
the competition and efficiency which will be afforded by the new business;
the introduction of new technology and skills to Australia;
the access to new export and local markets;
the utilisation of Australian materials and labour;
the involvement of Australians in the management and on the Board of Directors of the business.

It is very difficult to determine whether any particular proposal will be approved by the Board. The only satisfactory way is to submit the proposal for its review. However, in general terms, the Government has announced that the Board will make every endeavour to advise constructively on proposed new investment and to make recommendations as to ways and means by which the proposal will satisfy the guidelines.

For example, there have been cases where for one reason or another a proposal has not satisfied the guidelines as to 50 percent Australian equity. If the business is one which the Government is anxious to obtain in Australia, it has approved the proposal with a recommendation that as soon as circumstances are appropriate the Australian equity should be raised to the requisite percentage.

Recently, the Government has announced that it is considering a relaxation of the guidelines with a view to stimulating more foreign investment in Australia.

*(2) Reserve Bank*

The Bank has the authority under the Exchange Control Regulations made by the Federal Government to control not only the movement of currency both to and from Australia, but also a number of arrangements entered into by Australian residents with non-residents.

In these Regulations the test is one of *residence* which, in the case of an individual, means a person who is ordinarily resident in Australia and, in the case of a company, one which is incorporated in Australia but also one which is incorporated outside Australia if it has a place of business there.

All contracts, agreements or arrangements, of whatever nature (except contracts for the purchase of goods), entered into by a resident with a non-resident must have the prior approval of the Reserve Bank.

In addition, any agreement relating to an Australian asset made between two non-residents requires the approval of the Bank. For the purposes of these Regulations and the Foreign Investment Review Board, such a transaction is treated as a new dealing.

All borrowing by Australian residents from non-residents and the allotment or transfer of securities, including shares, to non-residents, also require the Bank's approval.

In recent years, the Government has on a number of occasions introduced a Regulation requiring a resident who is borrowing from overseas to deposit with the Bank a portion of those borrowings free of interest.

Currently, there is no such requirement. If the borrowing does not exceed $200,000 no approval is required.

If it is intended to open a branch office in Australia or incorporate a subsidiary company in Australia (these matters are dealt with a little later), the approval of the Reserve Bank will be required. However, it must be borne in mind that when the time comes to remit any profits or capital moneys to a non-resident, the Bank's approval will be required.

Currently the Bank does not purport to restrict the movement of such moneys out of Australia, but it will not give an advance ruling of the policy which may be applicable at a future date.

The Foreign Exchange Regulations also require a licence for the export of certain goods from Australia. Normally these are granted by the Bank.

In addition to its normal function, the Bank is required to obtain a clearance from the Commissioner of Taxation with respect to transactions with certain specified countries regarded as tax havens and the Commissioner will need to be satisfied that the transaction will not result in the avoidance of Australian tax.

### B. STATE GOVERNMENT

Apart from the general necessity to comply with the laws of the State in which the foreign investor is conducting his or its business, it may be necessary to negotiate a special agreement with the Government of that State. A common example of this type of agreement has occurred in the past in cases where companies are mining, transporting and exporting minerals such as iron ore and coal from Australia.

Normally, transport and other facilities, such as railways and harbours, are controlled and dealt with by instrumentalities of the State. The purpose of the agreement, which is ratified by a special Act of Parliament of the State, is to permit the company concerned to conduct the full range of its operations.

For example, in Western Australia there are a number of special agreements permitting companies to mine, transport by rail and export on ships, iron ore. This type of agreement normally permits the company to construct roads, construct and operate railways, construct and operate a port, construct towns and other facilities. Without the special agreement the company would not be able to conduct the full scale of its operations.

## 2. How should the business be conducted in Australia?

(a) *The establishment of a branch in Australia of the foreign company*. This will necessitate the registration of that company as a foreign company in the State concerned. There are certain formalities prescribed by the Companies Act and Regulations of each State requiring the filing of various documents in the State concerned.

(b) *The incorporation of an Australian company in the State concerned.* This may be incorporated as either a public or private company depending on the circumstances. In the former case, there must be a minimum number of five members, while in the latter case the number of members can be between two and fifty.

In most cases the incorporation will be as a private company as this will cover the cases where:

(i) it is a wholly owned subsidiary of the foreign company; or
(ii) the foreign company wishes to conduct a joint operation with an Australian company or individual.

The Companies Act of each State requires that in the case of a private company at least one director be an Australian resident. In the case of a public company, at least two directors must be Australian residents.

(c) *Joint venture.* If it is intended that the business will be conducted in conjunction with Australian residents, a joint venture may be considered as an alternative to a jointly owned Australian incorporated company. The basis of a joint venture is that each joint venturer receives a share of the product produced or manufactured by the joint venturers and can claim as a tax deduction its contribution to the costs of the joint venture.

As an alternative, the business can be conducted in conjunction with an Australian company or resident through a partnership as distinct from a joint venture.

(d) *A sole trader.* This would be applicable in the case where a non-resident wishes to conduct his business in Australia in his own name and not through a company, joint venture or partnership.

(e) *A trust.* Under this type of arrangement the trustee (normally a company) conducts the business for the benefit of specified persons or classes of persons. This type of operation has become popular in Australia in recent years because of income tax benefits set out later in this paper.

### 3. Income tax implications of the methods outlined under item 2

In general terms the liability to income tax in Australia depends on two tests:

(a) the residence of the taxpayer; and
(b) the source of the income.

Under (a) the taxpayer is taxed on the whole of his income wherever it may be earned. Under (b), if the taxpayer is not a resident of Australia he or it will be liable to tax in Australia on the income which is earned there.

A resident for income tax purposes is:

(i) an individual who resides in Australia or has been in Australia during more than one half of a tax year;
(ii) a company which is incorporated in Australia; or
(iii) a company incorporated outside Australia but which carries on business in Australia and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

The other important matter to be decided is the source of the income. This is determined by examining all aspects of the particular case to determine whether the income concerned has been earned in Australia.

To deal now with each of the situations under heading 2, the following is the position:

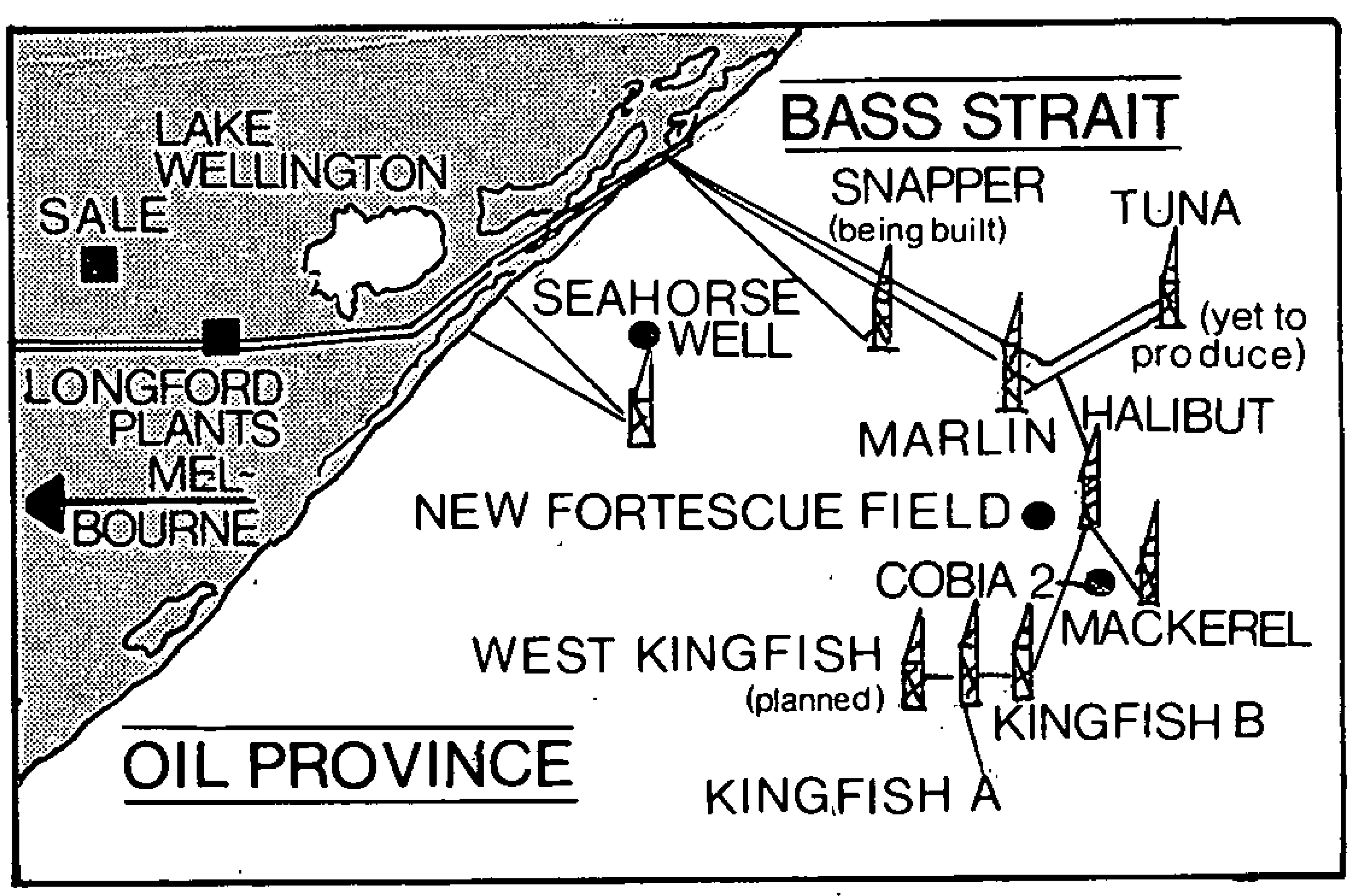
(a) *The Branch*
Income tax is payable by the overseas company on the profits or income which it earns in Australia at a flat rate of 46 percent. [2]

(b) *The Subsidiary Company*
Income tax is payable on the profits or income of

2. Increased recently by the introduction of what the Australian Treasurer calls a "branch profits tax".

**MAJOR OIL FIND OFF THE AUSTRALIAN COAST**

*The article of Mr. Blanckensee could not have been written at a more timely moment. When your editor was reading his article at the IFA Sydney Congress Australian newspapers announced a possible major oil find in Bass Strait which has since then be christened the Fortescue field. Later information proved the first announcements to be correct, the Fortescue field is perhaps the most important discovery since the big oil fields Kingfish, Halibut and Mackerel were found in the 1960s. It is estimated that the Fortescue field may contain between 100 million and 300 million barrels of oil and will help Esso and BHP to offset the expected downturn in Bass Strait production. The total yield of the Australian fields which are currently worked is around 380,000 barrels of oil per day which is sufficient to cover 64 percent of Australia's requirements.*



the subsidiary company earned anywhere, not only those earned in Australia by that company. Again, the tax is at the flat rate of 46 percent. If, however, the income earned by that company outside Australia is taxed in the country where it is earned a credit is given against the Australian tax for the tax paid in the other country. This constitutes a major departure from the practice previously adopted, namely, that if the income earned by a company outside Australia was taxed in the country where it was earned the income would not also be taxed by Australia. The change takes place as from 1st July, 1978. The other important feature of this amendment is that foreign source dividends received by an Australian company will now be subject to Australian tax and no rebate will be given. The credit to be allowed will include not only direct tax paid on the dividends in the other country but also foreign dividend withholding tax. In addition, a credit will be given in respect of part of the tax payable by the foreign company providing the dividends, where the Australian company has a shareholding of 10 percent in the foreign company.

(c) *Joint Venture or Partnership*
Income tax is payable by each joint venturer on the net income realised by the disposal of its share of the product less any deductions allowable to it which will include its contribution to the cost of the joint venture.

In the case of a partnership, no income tax is payable by the partnership itself even though a return of income must be lodged by the partnership. However, each partner is assessed to tax on his share of the net profits of the partnership irrespective of whether that share of profits is drawn by the partner or not. Similarly, each partner can claim as a deduction its share of any loss of the partnership.

If the overseas joint venturer or partner is a company, it will be liable to tax on its net income or its share of the profits of the partnership, as the case may be, at the rate of 46 percent. If the joint venturer or partner is an individual, he will be taxed at the applicable rate.

(d) *The Sole Trader*
Income tax is payable at the applicable rate, the maximum now being 61½ percent.

(e) *The Trust*
Income tax is payable by the trustee on any income of the trust which is not distributed but accumulated in the trust. The rate is 60 percent. However, if the income is distributed to the persons entitled under the trust deed those persons include in their returns the income of the trust which is distributed to them. If the income is distributed there is no tax payable by the trust as such and to this extent the trust is different from a company.

In addition to the direct tax payable by each of the abovementioned entities, there are further considerations which have to be taken into account.

Firstly, the Income Tax Assessment Act lays down certain tests to determine whether a company is a public or private company for income tax purposes. Normally, a company, whether a resident or non-resident, will be classed as a public company for income tax purposes if its ordinary shares are quoted on a stock exchange anywhere in the world *and* at no time during a tax year 20 or less persons held more than 75 percent of the ordinary shares of the company.

The significance of this test relates to what is commonly called "undistributed profits tax". If a private company does not distribute a certain proportion of its income to its shareholders within a prescribed period, it suffers an additional tax of 50 percent on the amount not distributed. This is in addition to the income tax mentioned above.

The amount required to be so distributed to avoid the undistributed profits tax is 40 percent of its net trading profit, and 90 percent of its net property income. This provision applies to a non-resident private company which carries on business in Australia through a branch and no relief from payment of this tax is given by a tax treaty.

Secondly, where interest is paid or credited by an Australian subsidiary company to its parent on moneys which may be borrowed from the parent, a withholding tax at the flat rate of 10 percent on the gross amount is payable. The Australian subsidiary company is obliged by the Act to deduct the Australian withholding tax.

Under the new branch profits tax, interest which is derived or deemed to be derived from Australian sources by a non-resident company will be subject to the 5 percent tax unless it is liable to interest withholding tax. However, the liability for withholding tax in this situation does not arise if the interest is derived by a non-resident carrying on business in Australia through a permanent establishment.

Thirdly, dividends paid by an Australian subsidiary to a foreign parent are liable to withholding tax at the flat rate of 15 percent on the gross amount. The rate will be 30 percent if the dividend is paid to a company situated in a country with which Australia has no tax treaty. Again, the Australian resident company is obliged to deduct the tax from the dividend before it is paid.

Fourthly, where a non-resident company has in the past elected to conduct its business in Australia through a branch, no withholding tax has been payable. However, the Government has very recently announced that it intends to levy an additional tax on profits earned by an Australian branch of a non-resident company. The tax to be assessed will be 5 percent of income earned in Australia or derived from Australia by a non-resident company. The income on which the tax is assessed is the taxable income, namely, assessable income less allowable deductions of the non-resident company but excluding the following types of income:

(i) dividends which are included in the assessable income;
(ii) amounts included in the taxable income of a non-resident from operating ships in Australia; and
(iii) certain other amounts applicable to non-resident insurers and life assurance companies.

Fifthly, royalties paid by an Australian resident to a non-resident are deemed to have an Australian source and the Act obliges the person or company paying the royalty to a non-resident to deduct the tax from the royalty payment. The rate is 10 percent in the case of a royalty payable to a country with which Australia has a tax treaty unless the company receiving the payment has a permanent establishment in Australia, in which event it will be subject to tax at the normal rate. If the royalty is payable to a company resident in a country with which Australia has no tax treaty the royalty will be assessed to Australian tax as ordinary income.

The term "royalty" is given a very wide meaning under the Act. It includes payments made for:

(i) the right to use a copyright, patent, design, trade-mark, formula or other similar property;
(ii) the right to use industrial, commercial or any scientific equipment;
(iii) the supply of scientific, technical, industrial or commercial knowledge or information;
(iv) the supply of assistance in connection with the above matters.

Royalties of this type will be subject to the branch profits tax unless there is a specific treaty exemption. It must be noted, however, that the tax treaty will not give any exemption if the royalty is derived by non-residents in carrying on business through a permanent establishment in Australia.

Sixthly, Tax Treaties: Australia has concluded tax treaties with ten countries to give relief from double taxation. Those countries are France, Germany, Japan, Netherlands, New Zealand, Singapore, United Kingdom, Belgium, U.S.A. and Canada. The first seven are based on the 1963 OECD Draft Convention.

The general pattern of the treaties, particularly those based on the OECD Draft, is to effect a rate limitation on the country of source of 15 percent in respect of dividend income, 10 percent in respect of interest income and 10 percent or 15 percent in respect of royalty income, with the usual provisions that industrial or commercial profits arising from the operations of a permanent establishment in the country of source may be taxed at ordinary assessment rates in the country of source on so much of the income as is attributable to the permanent establishment, including dividend, interest and royalty income effectively connected with the permanent establishment.

In general terms a "permanent establishment" includes a fixed place of trade or business in which the business or enterprise is wholly or partly carried on.

Other industrial and commercial profits may be taxed only in the country of residence.

The treaties generally provide that in respect of dividend, interest and royalty income, the country of residence will grant a credit for the taxes paid in the country of source.

## 4. Deductions available for taxation purposes in respect of exploration incurred on petroleum operations

The Income Tax Act makes provision for a number of different types of deduction available for various items of expenditure incurred in connection with petroleum operations.

The main provisions are as follows:

(1) Expenditure incurred on exploration or prospecting in Australia for the purpose of discovering petroleum, and this includes natural gas. The type of expenditure envisaged under this heading includes geographical mapping, surveys and appraisal drilling.

The expenditures are now deductible against the taxpayer's income from any source, not necessarily income from petroleum, but other allowable deductions must be deducted against the income. Any excess expenditure may be deducted against income of the first subsequent year.

(2) Expenditure incurred in carrying on prescribed petroleum operations in Australia, which again includes natural gas. This expenditure is deductible against income from any source and is commonly referred to as "residual capital expenditure". The deduction is available over the lesser of five years and the estimated life of the field.

The type of expenditure covered here includes certain storage facilities at the site, drilling plant equipment, buildings and other improvements, water, light, power, etc. As a result of a recent amendment, the provision now includes expenditure incurred on plant which is used solely for the purpose of liquifying natural gas. However, the taxpayer is not entitled to claim as a deduction under this particular heading the following items of expenditure:

(a) plant for refining the petroleum;
(b) pipelines for the transport of petroleum;
(c) plant (including pumps, storage tanks, port facilities and other terminal facilities) used in the operation of the pipeline.

(3) If a contractor is paid by the owner of a Petroleum Prospecting Right for undertaking work which falls under either of the headings (1) or (2) above, the deductions are available to the holder and not to the contractor. If, however, the arrangement between the owner and contractor is constituted on a profit-sharing or farm-out basis where the contractor is paid a share of the income from the petroleum for the work carried out by him, the expenditure is allowable to the contractor.

(4) Certain items of expenditure are also deductible under the heading of Investment Allowance. The relevant provisions allow a deduction of 20 percent of expenditure incurred on certain new plant acquired or constructed by the taxpayer for his exclusive use in Australia for the purpose of producing assessable income. The conditions for a deduction are:

(a) the item must be acquired or constructed after 1 January 1976 and before 1 July 1985;

(b) the item must be first used or installed ready for use prior to 1 July 1986;

(c) the deduction is allowed in the first year in which the property is used or installed ready for use by the taxpayer.

The allowance does not apply to structural improvements, except in limited cases. For example, wharfs and jetties are excluded from the allowance. Most complete new items of plant are covered, but the allowance does not apply to re-conditioned or re-built items.

The important feature about this type of deduction is that it is in addition to any allowance for depreciation.

(5) The Act makes special provision enabling a deduction to be obtained for expenditure on certain facilities used primarily for the transport of petroleum produced in Australia. It does not, however, extend to facilities for the transport of refined petroleum but would, apparently, include the pipeline from the off-shore field to the refinery on shore, together with port facilities to the extent that they have not been allowed under another provision of the Act. The deductions can be taken over a period of ten or twenty years at the election of the taxpayer.

The Government has indicated that the deductions allowed under this heading will include harbour surveys, initial dredging of a harbour, channel construction, break-waters, access roads and communications and storage facilities for products awaiting shipment. This type of deduction will be available to a taxpayer who contributes towards the cost of the facility — he need not own it, nor need he have actually produced the petroleum.

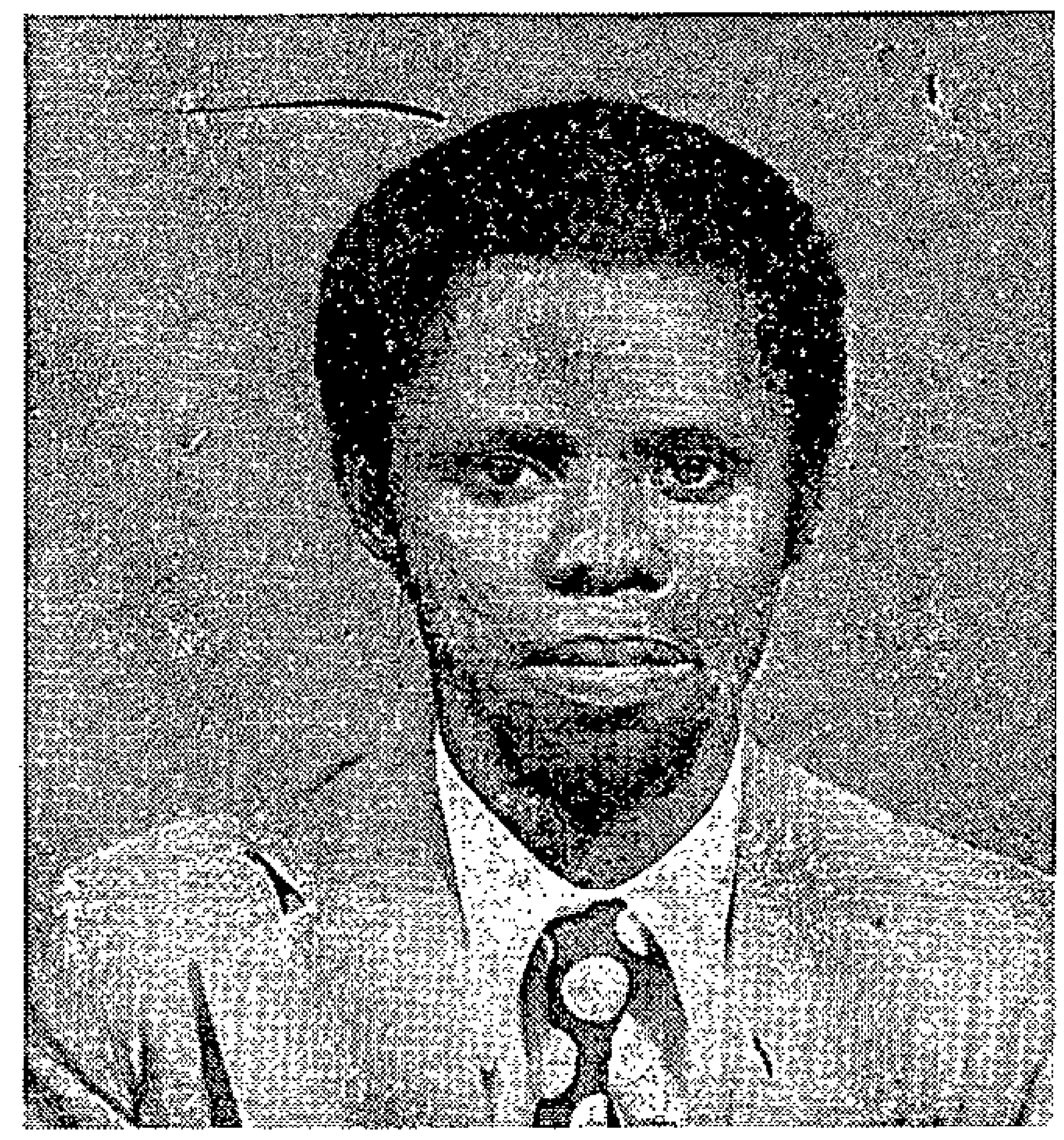
(6) There are also available deductions for depreciation of plant and articles owned by the taxpayer and used by him to produce assessable income. The rates vary from item to item and are prescribed by the Commissioner of Taxation as being rates which are reasonable for the particular item of plant and the operation in which it is being used.

It does appear that most of the facilities which do not qualify as residual capital expenditure referred to in item (2) above, or as port facilities under item (5) above, will be depreciable at the rate of 20 percent on the diminishing value. Some items, such as storage tanks, will be depreciable at the normal rates permitted by the Commissioner.

Problems will, no doubt, arise in determining which items of expenditure will fall under the heading, and in some cases the rates of depreciation will have to be agreed with the Commissioner. This type of operation is in its infancy as far as Australia is concerned and there will, no doubt, be many problems to be ironed out in this respect.

(7) Under the Income Tax Assessment Amendment Act, 1978 it is proposed to give a concession in respect of money subscribed after the 24th August, 1977 as capital to companies which hold licences or permits under the Petroleum (Submerged Lands) Act. The concession is designed to encourage exploration and development of off-shore petroleum fields and provided the company concerned makes the necessary declaration the shareholders will be entitled to obtain an income tax rebate in respect of their subscriptions provided the subscribed capital is spent on specified expenditure. The tax rebate will be 30 cents in each dollar of capital subscribed and will be available in the year of income in which the subscription is made.

# Nigeria
# Canons of Taxation and Personal Income Tax



by A.C. Ezejelue *

## I. IN GENERAL

### A. Meaning of a tax

Every club requires some contributions from its members to its treasury. These contributions are willingly made by the members because such membership is not forced. Besides, the members have a direct say on how the contributions are to be spent in their own interest.

Every government together with the citizens who are governed may be regarded as a club; the difference being that such citizenship or membership of the government territory and the contributions of such members to the government treasury are compulsory. Also the members who either reside or derive income within the government's territorial boundaries may not have a direct say on how their contributions are to be utilized to satisfy their individual and collective interests. It is more so in a military regime. Hence a tax which is such a contribution to the government treasury is defined as "a compulsory payment for which the government need offer no service or explanation".[1] Payment of tax implies the settlement of the taxpayer's liability to the government. Government expenditures of tax money are often so deeprooted in political ideology that they form the main cause of political dispute.

### B. Canons of taxation

Since tax is a compulsory payment for no guaranteed compensatory benefit, there is always a search for criteria or scales of values which serve as a touchstone for judging any tax. The most widely known of these rules and principles for evaluating any tax are Adam Smith's[2] Canons of Taxation which are as follows:

(1) *Equality of sacrifice:* "The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the State."

(2) *Certainty:* "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person."

(3) *Convenience:* "Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."

(4) *Economy:* "Every tax ought to be so contrived as both to take out and keep out of the pockets of the payer as little as possible over and above what it brings into the public treasury of the state."

The above canons which have their economic implications are based on social justice and are related to utility criteria.

### C. Modern implications of the canons

For the canons to be useful today, in any country, they require interpretations which will take care of the environmental and societal circumstances of the particular economy. This will include interpretations that are related to the structural, behavioural and cultural idiosyncrasies of the people concerned. The meaning will also be extended to cover the peoples' beliefs, convictions or a body of tenets acceptable to them. It will eschew any foreign elements. Afterwards, Smith's prescriptions were a reflexion of contemporary opinion in

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* Senior Lecturer in accounting, Department of Accountancy, University of Nigeria.

1. Henry Toch, *Income Tax (including Corporation Tax and Capital Gains Tax)* (London: Macdonald & Evans Ltd., 1969), p. 1.

2. Adam Smith, *Wealth of Nations*, 1776, Book V, Chapter II, part 2.

**Editor's note:** *There are a number of fundamental principles underlying an income tax, which are equally valid in developed and undeveloped countries. However, most African countries have still tax laws which were imposed on them by the former colonial governments. These tax laws were developed in Western countries which have a profoundly different economic and social structure and are, therefore, not always suitable for a specific African community. Mr. Ezejelue demonstrates this in the special case of Nigeria.*

Britain on social justice and economic and social development.

No matter how we look at the modern interpretations of the canons, the meaning abounds in conflict depending on the political ideology of the people in power. For example, there may be as many varying viewpoints on the implications of social justice as there are political leaders. Nonetheless, if reasonableness is brought into play, agreement will be reached regarding acceptable interpretations of the canons in the light of each modern economy. "There are areas in taxation where reasonable men might get together even though their sympathies were at opposite poles." [3]

There are other practical difficulties in the actual implementations of the canons. It is possible that for a tax system to satisfy one canon it may infringe another. This conflict will be likened to the conflict in human behaviour arising between telling the truth and hurting a person's feelings by so doing.

*Equality of sacrifice*

The modern implications of the first canon of "equality of sacrifice" lie in the equitable distribution of the tax burden among all. But since equity is an ethical rather than an economic concept there are bound to be differences in personal predilection regarding what equity is. However, three standards of equity have been accepted for this purpose: *ability-to-pay, universality of tax payment and benefits received.*

The most widely accepted of these standards is the *ability-to-pay principle* which rests on the premise of taxing people of equal ability equally and people of unequal ability unequally. A measure of ability-to-pay rests partly on income and wealth and partly on the person's domestic circumstances. The theory of ability to pay may be derived partly from the economic concept of marginal utility of income. "According to this view, as income advances, the importance of another dollar more or less decreases. Thus, taxing higher incomes involves a lesser sacrifice than obtaining revenue at the bottom of the income scale." [4] Taking this view a little farther, Rolph and Break argued that "... the utility of a dollar to a person with a large income is smaller than the utility of a dollar to a person with a small income. Equalization would increase the sum of the utility of two people who initially had unequal incomes because the utility taken away from the more affluent person would be less than the utility gained by the less affluent one." [5] However intuitive or logical this hypothesis may appear, its realism is difficult to text because, as Groves puts it, "... the value of money and the pain of taxes to individuals is a psychological phenomenon, impossible to measure, and differing among individuals according to temperament. Additional income may mean much to A, who is materialistic, and very little to B, whose interest in life runs in other directions." [6] Notwithstanding all that may be said about this principle, "The consensus of opinion of the democracies of the Western World is that the ability-to-pay theory is fair and equitable." [7] The theory calls for progressive taxation and is based on the philosophy of egalitarianism.

For this principle to have its full impact, particularly in most African countries, it must be fully adjusted to the taxpayer's domestic circumstances. Income and domestic circumstances are factors of ability-to-pay, particularly in many African countries. It is often expressed that in most African countries, domestic circumstance is a unique feature not quite identical to low income levels. Aggregate income differentials are universal, but pre-tax personal disposable incomes are more variable in many African countries than in any other developed society. For instance, let us imagine two male taxpayers A and B with the following personal circumstances:

| | A (in Naira) | B (in Naira) |
|---|---|---|
| Aggregate income per annum | 6,000 | 6,500 |
| Marital Status | Married with 2 children | Single |
| Relatives/ Dependents | Father (earns 12,000 p.a.) | Father (destitute) |
| | Mother (Seamstress and earns 3,000 p.a.) | Mother (Petty trader and earns 800 p.a.) |
| | Four brothers (average income 8,000 p.a.) | Six brothers (all in school) |
| | Other relatives (6) (average income 5,000 p.a.) | Other relatives (2) (average income 1,000 p.a.) |

A and B may appear to be two extreme cases but in reality they represent two typical Nigerian taxpayers. Although B earns more than A, the latter is more financially comfortable; hence he is able to maintain a wife and two children. For B, ability to marry is a function of income and domestic circumstances; so is his ability to pay tax. He cannot easily afford to marry or pay high tax because of Nigeria's socially transmitted behaviour pattern and belief, the so-called "extended family system". B's relatives have automatically become his dependents. But for A the reverse may hold because he can fall back on his parents and wealthier relatives for financial support. Yet B is not a unique Nigerian. He is an average, typical Nigerian; he is a reality.

The realism of the test of equality of sacrifice or the pain of taxes here cannot entirely be explained away by the individual's psychological phenomenon or temperament, as Groves suggests. It is a physical fact of poor parental, social and economic "roots" and a binding to these "roots" which are easily identifiable and measurable in the Nigerian society.

3. Harold M. Groves, *Trouble Spots in Taxation* (New Jersey: Princeton University Press, 1948), p. 3.
4. Harold M. Groves, Ibid., p. 8.
5. Earl R. Rolph and George J. Break, *Public Finance* (New York: Ronald Press Co., 1961), p. 95.
6. Harold M. Groves, *op. cit.*, p. 8.
7. G.W. Thatcher et al., *Tax Revision Alternatives for the tax system of Ohio (A Research Study)*, 1962, p. 51.

Therefore, one cannot divorce any of the factors from the principle and still retain the full impact of the principle in the light of our African environment where personal circumstances vary and incomes are generally low. As quoted in Seddon's book, "... there is more need in equity to adjust tax to details of individual circumstance where incomes are in the lower ranges than there is when they are on the higher levels." [8] Therefore, domestic circumstance as an attribute of ability to pay will have greater impact in developing countries than in developed countries.

The other standard of *universality of tax payment* implies that for a tax to be equitable it should be universally imposed without discrimination or distinction between individuals similarly placed.

The *theory of benefits received* demands in principle that the amount of taxes paid by each person in a society be equal to the value of the services provided by government activity. This rule implies measurability and traceability of government expenditure to individuals. It is difficult to measure and assign the benefits of government expenditure to the individual taxpayers, or to establish a direct quid pro quo between the tax paid and the benefit received. Therefore, this rule does not seem to be practicable. Besides, this principle will be least applicable in some developing economies like Nigeria where some sections of the rural population may benefit little or not at all from government expenditure. Such sections may lack roads, water, electricity, health and postal services and even education; yet the compulsory nature of personal income tax requires that they discharge this civic responsibility. However, the modern test of this theory seems to lie in the ability of the state to provide, subject to its finances, some common services and amenities which will benefit at least the majority of the population.

All the other canons of taxation — certainty, convenience, economy and efficiency — have their deep rooted implications for social justice. In an attempt to summarize their modern implications, Seddon argued that "the individual should know with certainty what his liability will be in order that he may make adequate provision; that taxes should be levied in a way which does not disrupt the private activities of the individual; and that he should see the revenue to which he has contributed used without waste." [9] In other words, taxes should be convenient, certain, clear and not arbitrary. Also there are costs in administering any tax system. These costs include cost of collection of taxes to the government, cost to the employers who are tax collecting agents under a PAYE system and costs to the taxpayers in the form of record keeping and time to complete the tax returns. An economical and efficient tax system calls for minimizing these costs. A simplified tax law and good procedure will help to minimize these costs and maximize revenue. The lower these costs, the more the resources that can be available for use in the economy. Economy also implies optimum utilization and efficient allocation of the resources of the economy.

## II. THE NIGERIAN SITUATION

The Income Tax Management Act 1961 (ITMA) is the mother Act guiding personal income tax in Nigeria. It laid down the broad principles of the personal tax structure in Nigeria and introduced some measure of uniformity.

Despite the attempt at uniform principles by the ITMA 1961, some differences existed notably in rates of tax, allowances and reliefs among the various States in Nigeria. To further unify personal tax principles, an amending decree, the Income Tax Management (Uniform Taxation Provisions, etc.) Decree (No. 7) 1975 (Uniform Taxation Decree for short), was promulgated. The Decree was epochal in the evolutionary processes of personal income tax in this country and made the boldest attempt to unify our tax principles. Therefore any appraisal of the personal income tax in Nigeria in the light of the canons of taxation will mean the appraisal of Uniform Taxation Decree 1975 as amended by the Finance (Miscellaneous Taxation Provisions) (No. 2) Decree 1977 (Decree No. 61). The main provisions of the Uniform Taxation Decree — relevant for our appraisal in this paper — include, in a nutshell:

(1) Personal relief of 600 Naira to be granted to every individual whose income is subject to assessment.

(2) Relief of 300 Naira for wife to be granted to a married man who at any time during the year preceding the year of assessment had a wife living with or maintained by him, or a deduction of the amount of any alimony not exceeding 300 Naira paid to a former wife under an order of a court of competent jurisdiction in the case of an individual whose marriage has been dissolved.

(3) A relief of 250 Naira in respect of each unmarried child maintained by the taxpayer during the year preceding the year of assessment, subject to a maximum of four children: provided that on April 1 of that preceding year the child is not up to sixteen years of age or is studying full-time in a recognised educational institution or is serving under articles of indenture in a trade or profession. No additional relief will be granted in respect of education of a child covered by the children's allowance.

(4) A dependent relative allowance not exceeding 400 Naira is granted to a taxpayer who during the year preceding the year of assessment incurred costs in maintaining or assisting to maintain a close relative or that of his/her spouse: provided (a) that the relative must be either incapacitated by old age or infirmity or is the widowed mother of the taxpayer or the taxpayer's spouse, and (b) that the income of the relative in the year preceding the year of assessment did not exceed 600 Naira.

The most recent amendments of some of the provisions of the Uniform Tax Decree are contained in the Finance (Miscellaneous Taxation Provisions) (No. 2) Decree 1977 (Decree No. 61). This Decree, which took effect from 1 April 1977, amended the Income Tax Management Act 1961 as amended by the Income Tax (Amendment) Decree 1968 and the Income Tax (Uniform Taxa-

8. Edmund Seddon, *Economics of Public Finance* (London: Macdonald & Evans Ltd., 1968), p. 73.
9. Edmund Seddon, Ibid., p. 71.

tion Provisions) Decree 1975, and provided, among other things, for increases in personal allowances particularly in respect of married women and widows. Specifically some of these latest amendments are:

(1) The personal allowance previously fixed at 600 Naira is now increased to one-tenth of earned income, if greater than 600 Naira.

(2) The dependent relatives allowance is still 400 Naira, but may now be granted to any person who has an income in his or her own right.

(3) A widow who remarries shall be allowed a deduction of 250 Naira for every child (up to a maximum of four children) in respect of the children born to her by her deceased husband.

(4) Guaranteed minimum tax of one per cent of the total income.

(5) A more progressive increase in the rate of tax payable by persons in receipt of higher incomes. [10]

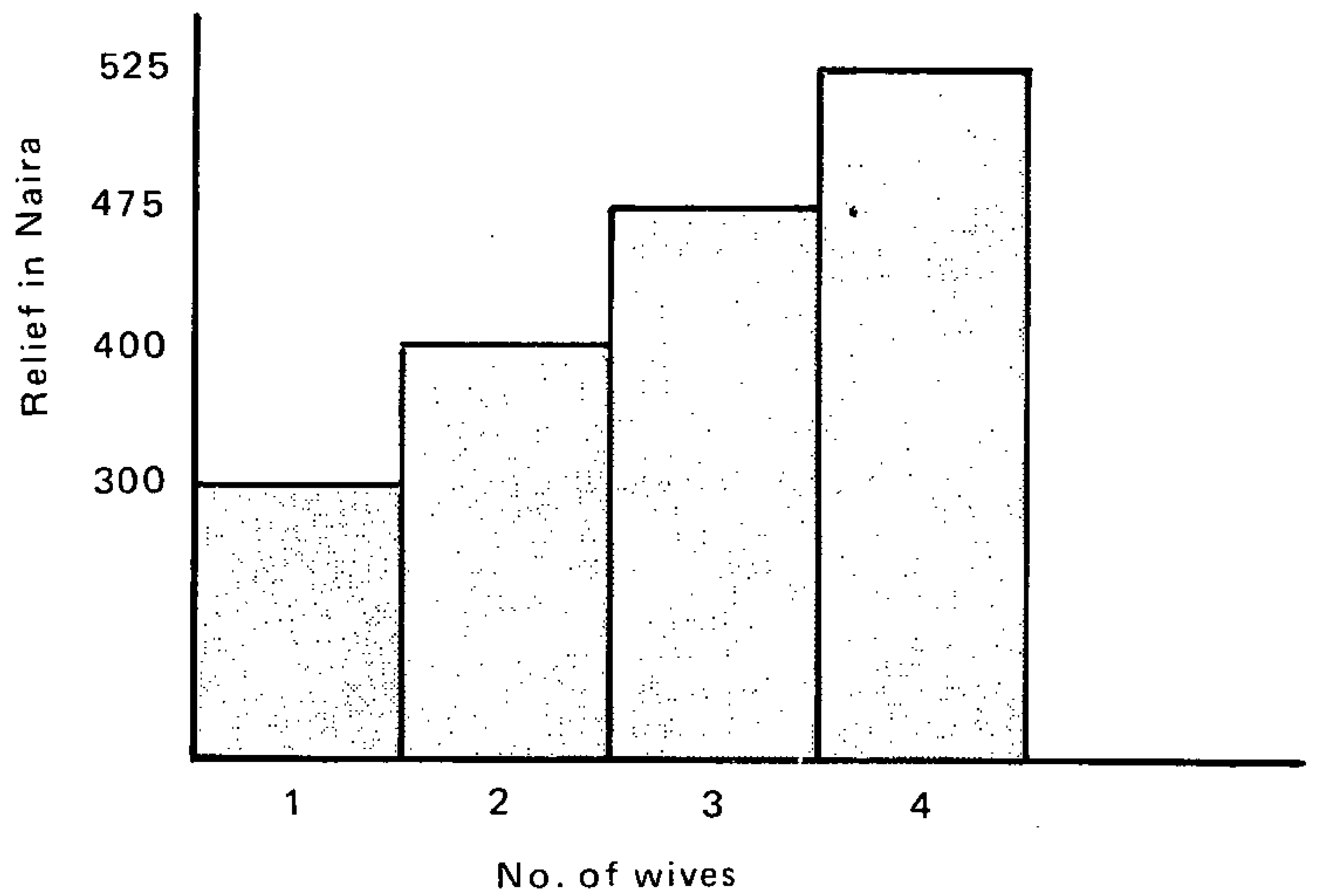
## III. REVIEW OF SOME NIGERIAN PROVISIONS VIS-A-VIS THE CANONS

### A. Relief for wife

Although this tends to uphold the ability-to-pay principle as regards the married male taxpayers who, presumably, maintain their wives, it transgresses the same principle for some married female taxpayers. It is a common feature of a typical African society to find female breadwinners in the family. A good example is a woman who maintains her husband in an educational institution. Such a woman pays her husband's school fees, gives him out-of-pocket allowance, maintains the children and runs the family. There are also cases of women carrying the family burden because the husband is either indolent and lazy, or is poorly placed, or is retired from active service, or is disabled or otherwise incapacitated by infirmity or old age. The canon of equality of sacrifice suggests that a woman in this kind of circumstance should have additional tax shelter over other women with dissimilar circumstances. It is only fair that where the man is relying entirely on the wife, this relief should revert to the wife. But there is no such provision in our tax law. The operative words should have been "marriage" and "maintenance", so that the relief reverts to either the husband or the wife depending on who maintains the other. As one of my past students [11] suggested, it should be known simply as "Marriage Relief". The old African idea and belief that the man is the sole breadwinner is unrealistic in the present-day Nigerian society.

Nigerian law on the relief for wife recognises only one wife. This is not being African; it has a foreign element. Unlike the European culture, our culture accepts and embraces polygamy. It has been our way of life for ages. Therefore granting of relief for only one wife in a culture which is basically polygamous negates the primary objective of relief and violates the ability-to-pay theory. For many acceptable reasons such as where the first wife is barren, or where for health reasons the first wife stops giving birth after the first issue, or where all issues are females, Nigerian society expects a man to marry more wives. Child bearing is the prime motive of marriage in our society. Therefore, rather than our tax system not recognizing our polygamous background for purposes of relief for wife, it could recognize it in an attenuated form for the additional wives after the first by graduating the relief downwards for the marginal wives. Thus:

**Figure 1**




This will have the multiple advantages of respecting our polygamous culture vis-à-vis our tax system, of upholding the principle of ability-to-pay, and of recognizing the premier place of the first wife.

### B. Relief for children

For this purpose our law recognizes only four unmarried children. This again is foreign to our culture and infringes on the ability-to-pay principle. Since our culture recognizes polygamy, we will be blowing hot and cold if we let our tax system appear to frown at too many children. To grant this relief subject to a maximum of four children will be punitive to the majority of taxpayers who belong to the low income group with high birth rates. About 80 percent of Nigerians still belong to the low income brackets and within this group an average family may have at least six children. The reasons for the large families among those in this group may not be far to seek: for example, there is the natural tendency and pride for a typical Nigerian to have as many children as may be naturally possible, and also there is the ignorance and lack of knowledge of modern methods of birth control. Therefore, granting of this relief with respect to four out of the numerous children

10. A comparison of the rates of tax under the 1975 and 1977 Decrees shows the following:

| *Income to be taxed* | *1975 Decree* | *1977 Decree* |
|---|---|---|
| For every ₦ of the next ₦ 5,000 | 35 percent | 40 percent |
| For every ₦ of the next ₦ 5,000 | 40 percent | 45 percent |
| For every ₦ of the next ₦ 10,000 | 45 percent | 55 percent |
| For every ₦ over ₦ 30,000 | 50 percent | 70 percent |

(See Schedule 4, Table 2 of 1975 Decree and Section 2(e) of 1977 Decree.)

11. Mr. Simeon Umoette belonged to the 1976/77 class that studied "Taxation Laws and Accounts" under me.

in the family will make the poor relatively poorer in comparison with those in the high income ranges who are usually more educated and may have less propensity for large families. The effects of this will be, among others, to negate the good idea behind the granting of such relief, to transgress the ability-to-pay principle, to be punitive to the poor man with his large family, and to act as a disincentive to raising numerous children. If the intention is to control the birth rate, taxation is not a good tool for that. But this may not be the case since Nigeria has no problem of population explosion yet.

The fact that in applying this restriction to four children, a husband and his wife or wives not separated from him by deed or an order of a court of competent jurisdiction are treated as one and the same individual makes the section all the more unfair to those in the low income group because it is amongst them that polygamy and numerous children are more pronounced. Again, since by implication the children who are the subject of relief need not be the taxpayer's own children the section drifts further away from the ability-to-pay criterion. This is because there are many cases where, apart from maintaining his own children, a taxpayer also must necessarily maintain the children of his less fortunate or even deceased relative or friend. Such a situation is not uncommon. The inequity of the section is further highlighted by the prescription that the relief is in respect of an unmarried child. It is a commonplace in Nigeria that a son who has no earnings of his own, and who is maintained by the taxpayer in an educational institution, takes a wife who also has no income of her own. By our system, both the son and his wife will remain the responsibility of the taxpayer who cannot claim a relief in respect of that married son.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Finally, the Decree expressly provides that no additional relief will be allowed in respect of educational expenses on any child in respect of whom child relief is granted. This implies that the Decree contemplates relief in respect of educational expenses on any child for whom no child relief is claimable. Although this may be the implied intention of the Decree, there is no further provision for it in that or any subsequent Decree. In view of the craze for education in Nigeria, the absence of such a provision is inequitable — particularly to those in the low income brackets who are more likely to have more children to send to school. Unless there is an effective free educational policy to a certain level, non-provision of relief in respect of educational expenses to cover at least those children in respect of whom no children's relief is available flouts not only the equality of sacrifice principle but also violates the theory of economy. Since the Nigerian people place such a premium on education and are prepared to get it at all costs, and since economy implies maximum utilization and efficient allocation of the resources of the country to the benefit of the masses, this section violates the canon of economy and the benefit-received principle.

### C. Dependents' relief

Decree No. 61 of 1977 completely amended the provisions of Decree No. 7 of 1975 by replacing paragraph (c) of the earlier decree with the following: "a deduction of 400 Naira in respect of dependents maintained by the person which shall be allowed to every person in receipt of an income in his own right" (Sec. 2(d)(ii)). Granting that this complete substitution is actually intended, the amendment has removed all the conditions (e.g. old age, infirmity, close relative, maximum income of dependent, etc.) required to qualify for this relief as provided in Decree No. 7 of 1975.

The idea of dependents' relief in a country that has neither an unemployment benefits scheme nor social welfare services to take care of the sick, the old and the infirm is very sound. The lack of a social welfare scheme makes the less fortunate ones depend and rely on their more fortunate and better placed relatives for their existence — a phenomenon earlier referred to as the "extended family system". This system is such a common feature in our society that it has virtually become a part of Nigerian culture. Therefore, the granting of this relief is in recognition partly of this common tradition of the people and partly of the government relinquishing to the citizens her responsibilities towards her less fortunate ones. For this recognition to be meaningful within the context of the canons of "equality of sacrifice" and "economy" it has to be total and not partial as is the case today where every individual in receipt of an income in his own right is entitled to a maximum deduction of 400 Naira representing an allowance in respect of only one dependent maintained by him in the preceding income tax year. But the number of dependents usually imposed on a typical Nigerian family by circumstances varies from less than five to more than ten. Therefore, for each taxpayer to be entitled to only a relief representing an allowance for one dependent does not only discourage taxpayers from assisting their less fortunate relatives in the absence of direct government responsibility for the incapacitated citizens, but is also counter to "ability-to-pay" and "economy" principles. For these basic canons to be met the Decree should recognize differences in the number of dependents maintained by each taxpayer. It is suggested that rather than restrict the relief to one dependent, the relief could be graduated downwards as in Figure 1 for the additional dependents after the first one. This will make it appear more egalitarian.

### D. Timing of tax payment and granting of relief

For those on the PAYE system the timing of tax payment is convenient both to the taxpayer and the tax collector. The annual tax is deducted piece-meal in nearly equal instalments from the monthly emoluments of the salary earner. The taxpayer hardly feels the impact as he would if a lumpsum payment were demanded. The tax collector also collects the proceeds with the greatest ease. This makes for economy because the cost of administration is minimal to both the taxpayer and the tax collector. Tax evasion is virtually non-existent because the employer, who is usually appointed as a tax collecting agent in respect of his employees, is legally bound to deduct tax at source and pay some to the relevant tax authority within a specified time. However, the only cost of administration on the PAYE system is borne by the employers who operate the system on behalf of the tax authorities.

What is inequitable and contrary to the canon of convenience is the timing of the grant of relief to employees. Whereas employment income is taxed on a current-year basis, reliefs — such as for wives, children, dependents and life assurance — are based on the employee's domestic circumstances in the year preceding the year of assessment. The criteria of equity and convenience will be maintained if a taxpayer's income receives the full relief attaching to that income in the year the income is received.

On the other hand, for many of the direct assessment taxpayers, the timing of tax payment may not be convenient, but the timing of the grant of relief may be. For instance, a farmer may be required to pay his tax during the planting season (April to June) instead of during the harvesting season (August to December). Also a trader who is assessed on the preceding year basis (except to the extent that treatment of losses provisions can be applied to his advantage) may be required to pay tax based on preceding year income in the current year in which there is a loss. In both cases where the timing of tax payment is inconvenient to the taxpayer, there may be chances of attempted or actual evasion, which makes collection efforts difficult and inconveniencing. However, the timing of the grant of relief to the direct assessment taxpayers is convenient in the sense that both the taxable income and the relief are on the preceding year basis.

### E. Community development and benefits received

The benefits received principle, which is another extension of the canon of equality of sacrifice, demands in principle that the amount of taxes paid by a taxpayer be equal to the value of the services provided by government activity. Apart from the difficulty of measuring and tracing government expenditure to individual taxpayers, it is futile to expect a direct quid pro quo between tax paid and benefits received. However, the taxpayers have an idea of how best the tax yield can be disbursed, e.g. in providing amenities and common services such as defence, law and order, good roads, water, light, school, health and sanitation, parks, sewage, etc. that will reach a majority of the taxpayers. It is doubtful whether the majority of the taxpayers in Nigeria have access to some of these amenities. Again, the taxpayer is apt to know when the public finance is being managed against the public interest. For example, recent probes have shown how the taxpayers' money was mismanaged by some public officers. There are also cases of abandoned government vehicles, agricultural and engineering materials and equipment. These not only violate the benefit-received theory in principle, but they are also contrary to the canon of economy which implies optimal utilization of tax money without waste.

Because of the absence or slow rate of rural development many communities have embarked on development projects of their villages on their own. This spirit of self-help effort has so spread that it has become the order of the day. Rural communities are known to have built schools, hospitals, roads, post offices, markets and provided water and light with little or no government assistance. The contribution towards this kind of community development is in a way a tax voluntarily or compulsorily paid towards that project which otherwise the government ought to provide from the usual tax proceeds. Since there are many such communities requiring development, and considering the snail's pace at which government develops rural areas, donations from public-spirited individuals and compulsory levies towards community development ought to be encouraged by regarding them as deductible expense for tax purposes. Unfortunately, it is not the case in Nigeria today. But if this is introduced it will satisfy the principles of equality of sacrifice and economy to some extent. And since such projects usually involve voluntary donations as well as compulsory levies at the village level where every member is known, the levies possess some characteristics of a good tax and ought to be regarded as such to a large degree. The villagers have their sanctions for non-payment of such compulsory levies, and so there is no question of evasion which has become a permanent feature of our tax system. If this is brought into and recognised by our tax system it will make tax payment more universal.

### F. Universality of tax payment

It was possible that some people did not have to pay tax under the Uniform Taxation Decree 1975, depending on their domestic circumstances. For example, a person whose total income was 1,200 Naira and who was entitled to the full dependent's allowance and wife's relief was left with no chargeable income after all the deductions for relief were made. But the Finance (Miscellaneous Taxation Provisions) Decree 1977 improved this situation by imposing a guaranteed minimum tax of 1 percent of the total income. Under this Decree, where "a person has no chargeable income or where the tax payable on the chargeable income is less than 1 percent of his total income he shall be charged to tax at the rate of 1 percent of his total income."[12] This is an improvement on the relevant provisions of the Uniform Taxation Decree and it makes tax more universally payable by all persons who have income subject to tax. It does not make for a good system for a tax structure itself to make it possible for some people not to pay tax at all.

### G. Effects of the new rates and tax evasion

By increasing the rate of tax payable by persons in receipt of incomes above 10,000 Naira, the amending Decree makes the tax system more progressive and more in line with the ability-to-pay theory. Though this satisfies the criterion of equality of sacrifice it could be extortionary and have disincentive effect to extra effort. A steeply progressive tax system may also contrávene the theory of economy which demands that every tax ought to be so contrived as both to take out and keep out of the pockets of the payer as little as possible over and above what it brings into the public treasury of the State. In this country where tax evasion is rampant a steeply progressive tax system may make those who otherwise might not have liked to evade tax to indulge in, at least, partial evasion by understating their income and misrepresenting their domestic and personal circumstances. The biggest evaders of tax are the businessmen who revel in outsmarting the tax men. They not only indulge in partial evasion (of which some public servants could also be guilty), but also engage in total evasion by not being assessed at all. The businessmen also are those capable of making the kind of income that can come under the hammer of a steeply progressive tax structure. Therefore our tax rates should be such that they do not increase the incidence of evasion, particularly among those who think that it is heroic to dodge tax payment.

Other causes of high frequency of tax evasion among Nigerians include lack of knowledge of why tax should be paid, non-availability, non-codification, and non-specificity of the tax laws and, in some cases, lack of understanding of the laws. Our taxpayers need to be educated as to the meaning and implications of the whole fabric of a tax. Besides, our tax laws should not only be made available in a systematically codified manner but should also be written in a lucid, unmistakable ordinary everyday language, preferably in English and in the major ethnic languages spoken in the country. The codified tax law should also be specific as to its requirements. According to Colley and Newman, "... tax law must be specific. Taxes aren't levied just by chance, and the rules of tax law, while complicated, have a certain basic, logical structure."[13] At the moment, our tax laws are contained in a number of Acts of Parliament, Decrees, State laws and edicts, some of which are difficult to get even by tax practitioners, accountants, and students and teachers of taxation. Also, the language of some tax laws — particularly the ITMA 1961 — is so vague, incoherent and perambulating that they are difficult to interpret by students of accounting and law. If these improvements are brought within our tax system, they will not only minimize evasion, but will also make the system more efficient.

## IV. SUMMARY

A criticism of our entire personal tax system will probably take a different form. Therefore it is not the intention of the author to criticize but to appraise some important provisions of our personal tax law particularly as it affects personal allowances, rates of tax, willingness to pay, etc. in the light of the modern implications and extensions in the meaning of the established canons of taxation. Since many people, all over the world, have a strong aversion to tax payment despite its indispensability and compulsion, efforts should be made to make any tax system as attractive and as convenient as possible. This can be achieved by evaluating any system with the known criteria as modified to suit each particular economy.

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12. Section 2(b) of 1977 Decree (Decree No. 61).
13. Geoffrey M. Colley and Eric J. Newman, *Tax Principles to Remember* (Toronto: CICA, 1973), p. 1.

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# The Nigerian Budget 1978|79*

The Budget proposals for the financial year 1978/79 were outlined in a speech on March 31, 1978 by his Excellency Lt. General Olusegun Obasanjo, Head of the Military Government and Commander in Chief of the Armed Forces.

This was followed a day later by a Press Statement by the Federal Commissioner for Finance which went into more details regarding the various measures announced in the Budget speech. It is from that Press Statement that the extracts below are taken.

The Commissioner first summarised the major economic problems facing the Federal Government.

"Namely, shortage of essential commodities, inflation, a substantial rise in government expenditure occasioned by a determined development drive, inequitable income distribution, unsatisfactory growth in agricultural and industrial output, inordinate crave for imported luxury items, over-dependence on the oil sector from which there has lately been a declining contribution resulting in a widening disparity between Government resources and commitments, and balance of payments pressure."

He then went on to say that

"With the background of the economic disequilibria identified above, the 1978-79 Budget has the following main policy objectives:

(i) to re-order Government's priorities so as to ensure efficient utilisation of the limited resources;
(ii) reduction in Government spending;
(iii) to diversify our resource base and avoid lop-sided reliance on the oil sector;

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* Note submitted by Ms. E.A. de Brauw-Hay, senior staff member of the International Bureau of Fiscal Documentation.

(iv) to fight the present high rate of inflation with renewed vigour;
(v) re-distribution of income to arrest the apparent social polarisation;
(vi) to strive towards self-sufficiency in food and agricultural production;
(vii) to protect, encourage and increase local industrial production;
(viii) to relieve the pressure on our external account by influencing the volume, structure and direction of our imports, while placing more emphasis on the non-oil sector of our export trade."

The Budgetary measures aimed at achieving the above objectives include the following:

*Agriculture*

Much emphasis has been placed on this sector in the past couple of years in recognition of the critical role which agriculture plays in the nation's economy. The Government felt, however, that the situation with regard to domestic food production called for new incentives and accordingly the Budget approved the following additional measures in this field:

"(a) Integrated agricultural production and processing have been transferred from Schedule II to Schedule III of the Nigerian Enterprises Promotion Decree (N.E.P.D.)." (I.e. from enterprises in which Nigerians must have a majority interest to enterprises in which Nigerians must have at least a forty percent participation.)

"(b) All capital expenditure on plant and equipment incurred in agricultural production by companies and individuals will, apart from attracting existing capital allowances on the assets, enjoy an Investment Allowance of 10 percent.

(c) Where losses are suffered by a company engaged in agriculture, such losses can be carried forward from year to year without the present four-year limitation after the pioneer period for writing off from future profits in the same line of business.

(d) Where loans are granted by traditional lending authorities to aid investment in agriculture, the recipient of the interest on such loans will enjoy exemption from tax as follows:

| *Repayment period including moratorium* | *Grace period* | *Tax exemption allowed* |
|---|---|---|
| (i) Above 7 years | Not less than 2 years | 100% |
| (ii) 5 — 7 years | Not less than 18 months | 70% |
| (iii) 2 — 4 years | Not less than 12 months | 40% |
| (iv) Below 2 years | Nil | Nil |

(e) The exportation of imported food items shall be prohibited.

(f) Equipment leasing to agriculture will now enjoy capital allowance."

*Housing*

"In addition to the existing incentives for Housing, interests on loans for developing owner-occupier properties at a maximum of one house per family shall be tax-deductible, and such properties shall also be eligible for capital allowance on property values up to 100,000 Naira."

*Manufacturing industry*

"Because of the generally low rates of duty on imported finished consumer goods during the outgoing financial year, most companies postponed expansion of manufacturing capacity in favour of massive importation. Also, local value added has remained very low as little or no effort is being made to find out local substitutes for imported raw materials. The result has been foreign exchange drain. Efforts will now be made to correct this trend, and to this end, import duties on consumer goods and, where feasible, on imported raw materials, are being raised or imposed where it is feld that undue dependence on imports exists.
In the current budget, Government has approved a number of tariff changes not only to raise revenue but also as additional protection and incentives for local industries."

*Interest on foreign loans*

Interest on foreign loans is to be exempted from tax as follows:

| *Repayment period including moratorium* | *Grace period* | *Tax exemption allowed* |
|---|---|---|
| (i) Above 7 years | Not less than 2 years | 100% |
| (ii) 5 — 7 years | Not less than 18 months | 70% |
| (iii) 2 — 4 years | Not less than 12 months | 40% |
| (iv) Below 2 years | Nil | Nil |

*Taxation*

— *Company tax* — As part of the measure to mop up excess liquidity in the economy, and broaden the scope of Government's non-oil resources, the rate of company tax has been increased from 45 percent to 50 percent with effect from 1st April, 1978.

— *Advance payment of tax* — Where interim dividend is declared the tax element should be paid to Government not later than 30 days after the declaration of the interim devidend; any refund due shall, however, be made to the company at the end of the assessment year. Advance payment of tax on provisional profit shown in un-audited Annual Accounts shall be made within thirty days after the end of the company's trading year. Early remittance of dividend by non-resident shareholders shall be allowed where proposals are made for advance payment of tax on interim dividend and end of year provisional profits.

— In order to assure investors of more attractive returns on their investment and encourage the expansion of domestic productive capacities, the existing level of allowable dividend of 16.5 percent has been increased to 20 percent (i.e. 40 percent gross on a tax rate of 50 percent).

— *Airport tax and high way tolls* — Airport tax has now been raised from 1 Naira to 5 Naira and tolls on highways at the appropriate rates which are being worked out.

— *Tax clearance certificate* — The production of tax clearance certificate is now mandatory for all transactions with Government agencies.

— *Ports development surcharge* — To aid the development of the country's air and sea ports, a Ports Development Surcharge at the rate of 5 percent of the duty payable on all imports has been imposed.

— *Special levy on excess profits of banks* — In view of the new interest rate structure of which banks will be the main beneficiaries, the Federal Military Government has decided to impose a special levy of 10 percent on excess profits of banks in addition to the standard company income tax. The excess profit will be calculated by assuming the following to be normal profit:

| *Normal profits on capital employed* | |
|---|---|
| Paid up capital | 40% |
| Capital or statutory reserve | 20% |
| General reserve | 20% |
| Long term loan | 20% |

The current interest rates, which are considered very low by all standards, have been raised in order to:
(a) promote private savings;
(b) check inflation;
(c) improve resource allocation;
(d) encourage domestic non-bank finan-

TAXATION IN NIGERIA

Nigeria currently consists of nineteen states which to a certain extent have their own tax systems. However, most individuals and companies are subject to a uniform income tax. Customs duties are also uniform throughout the country.

*Individual Income Tax:*
rates range from 10-70 percent (on incomes over 30,000 Naira).

*Company Tax:*
50 percent on all income exceeding 6,000 Naira.

A summary description of the Nigerian tax system is to be found in *African Tax Systems*, a loose-leaf publication of the International Bureau of Fiscal Documentation.

cial institutions to buy Government bonds to be raised for financing development projects;

(e) attract foreign investment.

*Nigeria: Recent important tax changes*

Nigeria has made a number of tax changes in recent months which are of major importance to foreign interests in the country.

In June of this year it was announced that Nigeria has served notice of termination of its double taxation conventions with nine countries, viz.: U.K., U.S.A., Ghana, Sierra Leone, The Gambia, New Zealand, Sweden, Denmark and Norway, the termination to take effect from April 1, 1979. The reason given for the termination was that they had been inherited from Nigeria's colonial past and were no longer relevant in view of developments which had taken place since. Although the director of the Federal Inland Revenue Dept. has said that Nigeria does wish to negotiate replacement treaties no such negotiations have yet been started.

At the same time as the denunciation of the treaties was announced it was made known that foreign airline and shipping companies would no longer be exempt from tax. It was announced that Sec. 26(1) 9 of the Companies Income Tax Act, 1961 — which exempted from tax shipping and airline companies based in countries which offer reciprocal facilities to Nigerian companies — had been "repealed forthwith". The departmental instruction announcing the repeal made clear the reasons behind this measure viz.:

*"It will be observed that certain foreign airlines and shipping companies, especially those resident in developed countries, have in the past enjoyed tax-free operations in this country under the reciprocal provisions while their Nigerian counterparts are not yet in a position, or may not be able in the near future, to take advantage of similar provisions in the tax law of those countries. In the circumstances, it is considered that the result achieved is not truly reciprocal."*

Companies affected will be liable to a tax of 10 percent on all remittances abroad: the tax will be held on account until returns of Nigerian profits are filed for purposes of corporation tax and an assessment is made. The tax will apply as from June 1978 to companies resident in countries with which Nigeria has not concluded a tax treaty, otherwise from the date of revocation of the tax treaties, i.e. April 1, 1979.

The third and final measure announced had been foreshadowed in the 1977/78 Budget speech [1] and provided for the taxation of companies in the construction and building industry at the rate of 2.5 percent of turnover minimum, backdated to the 1977/78 financial year. The tax is based on a decree passed last year which was originally thought to apply only to partnerships and individuals. This was because the decree applied the tax to "persons" and the decree was an amendment to the Income Management Act, 1961 in which "person" is defined in Sec. 2 as including companies. However, section 5a to which the amendment was made, was added to the Act by the Income Tax (Amendment) Decree 1968 and specifically states that a "person" does not include a company. Now the authorities have announced that a new decree has been approved which will make it clear that the tax also applies to companies.

Observers attribute these measures to attempts to gain extra revenue in the face of falling oil receipts while at the same time discouraging imports. To what exent they are short-term measures or part of long-term strategy is still uncertain, however.

### BUDGETARY PROCEDURE

The normal budgetary procedure in Nigeria is that proposals are first discussed in the highest policy making body, i.e. the Supreme Military Council. After approval by this body they are announced over the radio and television by the Head of State. Subsequently the Commissioner for Finance gives a greater detail and a further breakdown of the announced measures, usually at a press conference. So far as the measures of the 1978-79 Budget are concerned they became effective on April 1, 1978. The Budget measures are usually later formally enacted in an Appropriation Decree.

An extensive list of the new rates is included in the Statement, examples of which are 5 percent (previously 4 percent) on savings deposits and 7 percent minimum, 11 percent maximum (previously 6 percent minimum, 10 percent maximum) on loans.

*Exchange control policy measures*

Policy measures intended to arrest the foreign exchange drain and ensure that the country not only continues to meet its international foreign exchange obligations but also maintains a reasonable balance of External Reserves include the following:

(i) *Import bill* — To reduce the import bill and thus conserve foreign exchange some non-essential commodities or commodities which can be produced in the country, have been placed under either import restriction or import prohibition.

(ii) *Over invoicing* — Measures are being taken to check the apparent overinvoicing of imported goods.

(iii) *Buying commission* — The payment of buying commissions shall be regulated, with a view to saving foreign exchange.

(iv) *Cash gifts* — The maximum allowance for cash gifts which Nigerian individuals and institutions can give in a year has been reduced from 500 Naira to 150 Naira for individuals, and from 1,000 Naira to 500 Naira for charitable organisations.

1. See Bulletin for International Fiscal Documentation 1978/2, Vol. 32, pp. 85-86.

# Forty Years

It was in 1938 that a small number of distinguished scholars met at the Peace Palace, The Hague, to found I.F.A. One needs only to look at and quickly go through the latest I.F.A. Yearbook to see how our association has grown in numbers, in geographical coverage, in significance as to its activities.

I have a special reason to offer I.F.A. my sincere and cordial congratulations on the occasion of its fortieth anniversary.

The special reason is that I represent I.F.A.'s only child, the International Bureau of Fiscal Documentation. The extraordinary thing is that the child was born when the mother was only a few months old, but in the taxation world biology is of no account. We all know that tax is a very fertile subject. Soon after I.F.A. was founded, the decision was made to create a centre of documentation to assist the members in their research in the area of international taxation. This centre, with its long and ugly name, had its headquarters in Amsterdam. The University and the Municipal Council of this city provided the necessary facilities and the then only full Dutch professor of tax law, P.J.A. Adriani of the University of Amsterdam, became the Bureau's first director. This was very proper because it was at his initiative that I.F.A. decided to create the Bureau.

Work started in September 1938 but only developed slowly for obvious reasons during the war years. Thanks to the foresight of Adriani, and his precise preparations for an expansion as soon as this would be possible, the Bureau coped with the avalanche of material which arrived after the war and which reflected the new significance of taxation in a world that had changed and would change much more in the years to come.

During forty years the Bureau developed. The staff of 2 is now 50. Its original budget of Dfl. 10,000 is now nearly Dfl. 5 million. Its library is in several respects unique. It assists researchers and people preparing doctoral theses from all over the world. Its long list of periodical and loose-leaf publications now covers the whole world.

This is not said to boast about achievements, if only because we in the Bureau know how much there is still to be done. All this is said to pay tribute to all those who over the years have co-operated with the Bureau in order to help it in trying to fulfill its task and to act in accordance with its objectives. Among those friends and colleagues from all over the world many are members of I.F.A. They have been of great help to the Bureau, just as the Bureau believes that it has been, and still is, useful for I.F.A. and its members, as was the intention of its founders.

During its last meeting, in May this year, the Bureau's Board of Trustees decided to celebrate the Bureau's fortieth anniversary by creating an Award. This Award is very simple and is granted, not in recognition of work done on behalf of the Bureau itself but, more generally, to those who have devoted themselves in an outstanding way to the furthering of knowledge, thinking and research in the field of international taxation. It was further decided to grant the Award — a silver medal — for the first time during this Congress which happens to occur in the very week that forty years ago the Bureau started its work.

There is a man in this audience today who, over many years and not always in agreement with the ideas, wishes and experiences of others, has devoted himself wholeheartedly to matters of international taxation — as a scholar, as an administrator, as a scholar again, as a consultant to international organizations. This man,

PROFESSOR STANLEY S SURREY

whose ideas are controversial to some and agreeable to others, was and is involved in the creation and development of an instrument to educate and train people from many developed and above all less developed countries, an instrument of which few if any people will deny the significance and efficacy. I am happy that this man is also one of the most active members of I.F.A. He is a modest man, and he is not even aware of what I am about to say.

I am very pleased that the Bureau's Board of Trustees have authorized me to honour and acclaim

**Professor Stanley S. Surrey**

by making him the first recipient of the Silver Medal of the International Bureau of Fiscal Documentation, because of the outstanding quality of his many and varied achievements in the international tax area in which both I.F.A. and the Bureau have been operating for forty years and which are so numerous that it would take too long to specify them. May I just mention his involvement in the International Tax Program of Harvard Law School and in the work of the U.N. Group of Experts on Tax Treaties between Developed and Developing Countries.

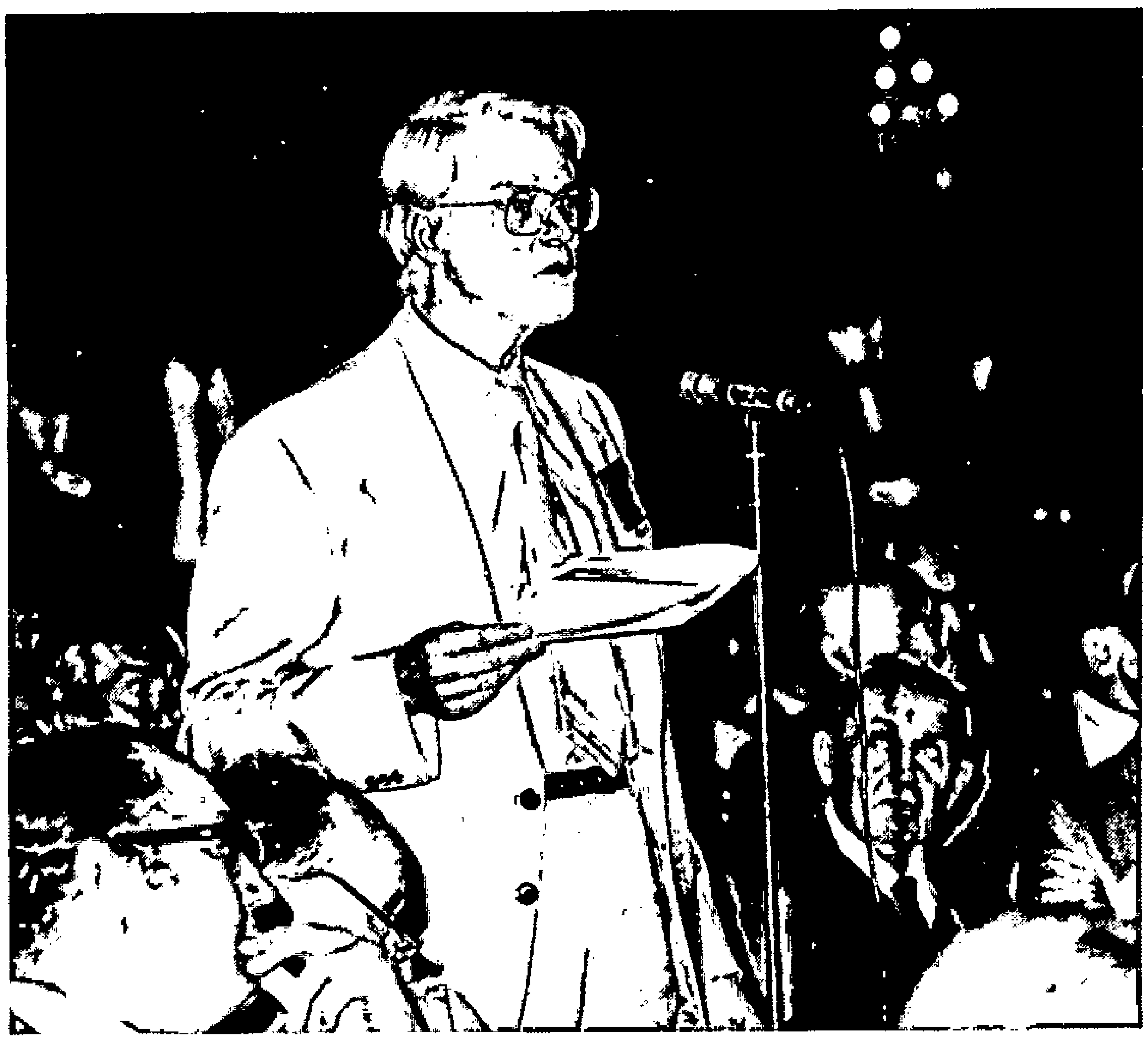
Many have benefitted from the Program and several of those are among us now. The work of Prof. Surrey as rapporteur to the U.N. Group is perhaps even of wider significance in the development of international tax law, as not only those among us who participated in the U.N. Group are aware.

May I now call Prof. Surrey to receive the Award as a token of great appreciation for his work, from the hands of one of the Bureau Trustees present here, Mr. Alun Davies.

Sydney,
22 September, 1978

J. van Hoorn, Jr.
Managing Director
International Bureau of Fiscal Documentation

Mr. Van Hoorn addresses Prof. Surrey



Prof. Surrey receives the award from Mr. Davies

# Some Highlights from the Secretary General's 1977-78 Report

At the highly successful 32nd Congress of the International Fiscal Association held from September 17-23, 1978 in Sydney, the Secretary General, Professor Dr. Jan H. Christiaanse presented his Annual Report covering the IFA's preceding year 1977-78. He noted the growing intervention of fiscal policy in the field of international fiscal law, both nationally and internationally and also a greater willingness of the states to cooperate in the fiscal field. This is not only reflected in the increasing number of tax treaties but also in the increased inclination of tax administrations to assist each other in various matters. IFA, of course, plays an important role in these international developments which can clearly be demonstrated by the large number of persons who participate in its annual conferences. The Congress held in Vienna in October 1977 had the highest attendance so far experienced by IFA in its history. However, the discussion at that conference did not result in regular resolutions. A summary of the first subject "Inflation and Taxation" was published in the October 1977 issue of the Bulletin and in the IFA Yearbook 1977 in which also an exposé of the second subject "The determination of taxable profit of corporations" appeared.

Further highlights are the following:

- On October 7, 1977 Dr. Paul Gmuer of Switzerland resigned as President of IFA and was succeeded by Mr. Alun Davies of the United Kingdom, who is a former President of the British Branch of IFA.
- During the Vienna Congress the 27th Branch of IFA was recognized, i.e. that of New Zealand, represented by its Chairman Mr. A.G. Little.
- Requests for the formation of new branches were received from Colombia, India, Indonesia, the Philippines and Singapore.
- In March 1978 IFA had 5,238 members (in 1977: 5,014).
- The Permanent Scientific Committee met in Rome in February 1978 where Messrs. Adonnino and Fantozzi acted as hosts on behalf of the Italian Branch of IFA. A large part of the meeting was devoted to a discussion of the Directives issued by the General Reporters on the first and second subject for the Copenhagen Congress to be held on September 4-8, 1979. These subjects are (i) The taxation of transfers of family-held enterprises on death and inter-vivos" and (ii) "The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities". The General Reporters will be Professor Dr. Thøger Nielsen and Dr. Gerhard Laule.
- The Permanent Scientific Committee also paid considerable attention to the choice of the subjects for the Paris Congress in 1980 (September 14-19, 1980). The following subjects were formulated. Subject I will concern "The dialogue between the tax administration and taxpayer up to the filing of the tax return". Subject II will focus on "The determination of the source of income". The General Reporters will be Mr. G. Delorme for the first subject and Mr. Robert J. Patrick for the second. On Wednesday September 17, 1980 a seminar will be held by the French branch of IFA on "The flight to tax havens, their use and abuse". (Le recours aux refuges fiscaux, l'usage et l'abus).
- The Executive Committee had to say goodbye to two of its members, Dr. Roberto Casas (Mexico) and Mr. Sidney I. Roberts (USA) who were required by the Statutes to resign. Their successors will be Mr. Rafael Caraz Excobedo (Mexico) and Mr. Richard M. Hammer (USA) who were present for the first time at the Spring meeting of the Executive Committee held in London in May 1978. The Executive Committee appointed three Vice-Presidents from among its members:

  Mr. Max Laxan — first Vice-President
  Dr. H. Fabricius — second Vice-President
  Richard M. Hammer — third Vice-President

  At the London meeting of the Executive Committee it was decided to recommend to the General Council in Sydney to increase the membership fees for 1979 to US$ 33 for individual members of National Branches, US$ 35 for direct individual IFA Members and US$ 77 for corporate members whether direct or through National Branches. [1]
- The rules for the competition for the Mitchell B. Carrol Prize have been changed. The Jury will henceforth be appointed by the Executive Committee from among the members of the Permanent Scientific Committee. Consequently, Dr. K.V. Antal, Professor J.I. Aguilar and Mr. L. Mehl resigned and Dr. J.B. Bracewell-Milnes and Professor Dr. K. Vogel have been appointed as new members of the Jury. At the Vienna Congress Mr. Jean Baugniet, the Jury's Chairman, presented the Prize to Mr. J. P. Foucault for his study "La fiscalité des groupes internationaux de sociétés". For the 1978 Prize only one entry was received, i.e. Mr. Greason Bryan's study "Developed national tax law and investment in LDC's, a comparative analysis".
- The General Treasurer, Mr. D. Coutinho, has expressed his wish to retire at the Sydney Congress. [2]

1. The Sydney Congress approved the increased membership fees.
2. Mr. Coutinho was succeeded by Mr. P. den Boer (Netherlands).

# SYDNEY CONGRESS 1978
# Resolutions on Subjects Discussed

At the end of the Sydney Conference of IFA the following resolutions were issued which reflect the results of the two topics discussed.

### Subject I: Taxation of extractive industries [1]

The 32nd Congress of the IFA discussed as its first Subject "Taxation of the Extractive Industries".

The Congress appreciated that the main concern in this area lies in reconciling the interests of governments with the interests of the extractive industries. Each national government is properly concerned with collecting as high a return on the depletion of the nation's natural resources as is consistent with what, in the opinion of the government, is the optimum development of such resources. The industry is concerned with the specific nature of its operations and is anxious that the particular problems which it faces should be taken fully into account when tax, or other laws, are being devised or amended.

The Congress agreed that the significant features of investment in the extractive industries are:

(1) the long periods inevitable before the already initially large investments gave rise to income;
(2) the risks that expenditure would prove to be abortive; and
(3) the fact that income could only be produced by depleting the resources which were being extracted.

The Congress, while recognising the sovereign right of countries to determine their own regimes, emphasised that it is unrealistic to expect capital to be put at risk unless there is a reasonable assurance that the investors will enjoy an adequate share of rewards for success. The stability of contractual arrangements and tax regimes is of paramount importance when commitments to large expenditure are made and they should not be changed except on the occurrence of entirely unforeseen circumstances.

The Congress concluded that this situation gave rise to important issues in legislation affecting both the countries involved and the industries, and the following points should specifically be emphasised:

(1) The allowance of initial expenditure only against income from extractive operations tends to favour established operators at the expense of newcomers and, furthermore, the barren years which a newcomer has to face before the generation of income against which allowances can be obtained will tend to deter investors.
(2) The costs of infra-structure should be taken note of and suitably considered in tax legislation. Similarly the increasingly desirable and necessary environmental costs should be suitably considered.
(3) The deductibility for tax purposes of allowed items should be suitably designed to operate effectively in cases of fluctuating profits profits or losses.
(4) The closing down of a resource which has been fully extracted or which has to be abandoned for economic reasons is an essential part of the operation of extractive industries and tax legislation should recognise that profits are often too low in the final years for the costs of closing down to be allowed in those years. Provisions should be included in tax legislation so that this expenditure can be effectively allowed either on a reserve basis, if this can be quantified, or in cases where quantification is not possible, by allowance when incurred or, if necessary, by carrying back for allowance against profits for previous years.
(5) The high financing costs of capital for the extractive industries whether raised domestically or internationally are often incurred for many years before income arises. These costs should also be suitably considered in tax legislation.

The discussions indicated that further study was required on the different aspects of the tax inter-relationship between the investing and the host countries, including the methods under which allowances are granted for double taxation relief.

In conclusion, the Congress considered that the subject gave rise to points which merited further study in Copenhagen under the heading "The effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated companies engaged in international activities".

### Subject II: Differences in tax treatment between local and foreign investors and effects of international treaties [2]

1. The study of the tax treatment applicable to income from foreign investments in the countries for which national reports were available, indicates that there exists a number of differences between the treatment of investments made by residents and investments made by non-residents.
   To a large extent these differences arise because the total tax burden on a non-resident's investment income results from taxation in the source country and also in the country of residence or the country of nationality of the investor.
   The scope of the subject under consideration at the 32nd Congress was limited to taxation in the country of source. It was nevertheless pointed out on many occasions that differences existing in taxation in the country of source can be affected by the tax treatment applicable in the country of residence or nationality and notably by the provisions such as those exempting foreign source income or granting foreign

1. The original version was drafted in English. French, German and Spanish versions are also available.
2. The original version was drafted in English. French, German and Spanish versions are also available.

tax credits, which are enacted in order to reduce international double taxation.

2. Much of the discussion was focussed on the following points:
   (a) taxation of permanent establishments of foreign corporations,
   (b) the status of tax incentives to encourage foreign investments,
   (c) international aspects of corporate imputational tax systems.

In the light of the discussion of these points, the Congress adopts the following resolution:

I. Considering the general concern expressed by delegates about the non-availability of double taxation relief to permanent establishments and considering par. 4 of the Resolution adopted by the 27th Congress of IFA in 1973, the Congress, recognizing that in many respects a local Branch of a foreign company is treated for purposes of income taxation in the host country as a resident company, proposes that further study should be devoted to the extent to which and to the circumstances under which a local Branch of a foreign company, which is engaged in the active conduct of a trade or business, should be accorded the benefit of provisions for the relief of international double taxation whether embodied in the domestic legislation of the host country or in double tax treaties to which it is a party.

II. Taking into account the existence of foreign investment encouragement policies in many countries, the Congress recognises the desirability of ensuring that the tax incentives adopted by countries to attract foreign investment should be effectively available to all enterprises to which they apply, whatever the nationality or residence of the owners thereof, and proposes that further studies should be undertaken of appropriate means whereby this result may be achieved.

III. Recognising that the statements made by delegates at this Congress have underlined the complexity of the different existing imputational tax systems, including differing effects on the dividend-paying corporation and on resident and non-resident individual and corporate shareholders, the Congress proposes that further studies should be conducted concerning the international aspects of corporation-shareholder integration.

# New Measures Reflecting Inflation in the Israeli Tax Legislation

By Dr. J. F. Pick *

In July and August 1978 the Israeli Parliament passed a number of amendments to the tax law, the main purpose of which is to take the effects of inflation into account. Even before these amendments were introduced a great number of provisions in the Israeli tax code did reflect inflation. They have been reviewed, partly before enactment, in previous volumes of the *Bulletin* (1975/9, 1976/12 and 1977/1).

Those older provisions include indexing of personal allowances (in the form of tax credits), full or partial indexing (indexing means linking to the cost of living or c.o.l. index) of tax brackets and social allowances, splitting of capital gains between inflationary and real gains (taxing the former at a rate of 10 percent only), allowance of 50 percent annual depreciation on industrial machinery, charging interest on tax debts and indexing them after a certain period and granting certain industrial enterprises with foreign participation an option to pay tax on the basis of accounts fully adjusted for the devaluation of the Israeli pound against the U.S. dollar.

While the above mentioned measures appear, in comparison with tax legislation in European countries, very far-reaching they still fall short of forming a consistent and comprehensive system of inflation adjustment. Nor are they being turned into such a system by three amendments introduced during the last term of Parliament.

In July 1978 the c.o.l. index in Israel was slightly more than five times its level of five years ago, i.e. an average annual rate of inflation of close to 40 percent, compared with less than 11 percent in the preceding five years. It is obvious that the adjustment of tax legislation to conditions of inflation is much more important at such a high long term rate of inflation than in countries with 5-10 percent annual inflation.

Except for the option of a fully devaluation-adjusted tax calculation under the so-called "Ronel" amendment, open to a number of manufacturing enterprises only, and the provision for 50 percent annual depreciation on industrial machinery, previous measures reflecting inflation in tax legislation did not affect the method of computing business income for tax purposes, i.e. it did not affect the tax base.

The adjustment of the tax base for the effect of inflation often faces a number of problems in different dimensions:

a) A full adjustment of tax accounts for the effects of inflation requires highly qualified skills in the tax administration and also acceptance in the tax-paying community. The economic and social costs of carrying out such adjustment add to many other objections against it.

b) In addition to the administrative problems it may be difficult to explain measures of inflation adjustment in the tax law to the taxpaying public. There has, for example, been much misunderstanding in Isarel concerning the charging of interest on tax debts from the last day of the tax year. In fact, that provision still allows a certain benefit to the taxpayer because the income has been earned gradually during the tax year, i.e. on the average at a lower price level than that of the last day of the tax year; but there have been strong protests against interest charges on tax debts for a period before the tax return has to be submitted and often even before the exact amount of income is known. It was in view of these protests that Amendment 32 to the Income Tax Ordinance (of August 1978) provided for the start of interest charges on debts for the tax year 1977 only on the date when the tax return has to be submitted provided the tax is being fully paid until the end of September 1978.

c) The administratively easier method of granting — instead of full inflation adjustment — some tax relief, generally or to certain groups of taxpayers, in a way that can be easily calculated, means often trying to offset the distortions caused by inflation by creating additional sets of distortions in the distribution of the tax burden. These distortions are mainly due to the fact that those measures of tax relief which are granted as substitutes for full inflation adjustment generally do not take into account the relation between own financing and borrowing which is most material in this respect.

## Inventory relief

A major adjustment of the tax base is included in Amendment 6 to the Law for the Encouragement of Industry of July 30, 1978. That amendment contains a provision for the deduction of 25 percent in tax year 1978 and 50 percent in tax year 1979 of the rise of the value of inventories of corporate manufacturing enterprises from their taxable income. The rise of the value of inventories is measured by applying the rise of the official index of wholesale prices of industrial products for local consumption to the inventories held at the beginning of the financial year.

Because in the debate on the effect of inflation on taxation of business profits the taxation of unreal profits on inventories and the insufficient depreciation of machinery on the basis of historical cost formed the main arguments in favour of some inflation adjustment, it would appear that together with the provision for 50 percent annual depreciation for industrial machinery, the inventory relief under Amendment 6 goes very far in meeting the demand for compensation for payment of tax on unreal profits, at least as far as the manufacturing industry is concerned.

* Certified public accountant.

Both measures may not offer a full inflation adjustment to those corporations which finance machinery and inventories fully by own funds. However, because the manufacturing industry in Israel is financed to a high degree by borrowing it is most likely that the two measures compensate industry on the whole fully for the tax effects of inflation. Upon repayment of debts a tax free profit is made "in real terms" by returning the same nominal amount in cheaper money.

The shortcoming of the inventory relief provisions is that they may overcompensate those corporations which lean most heavily on borrowed funds, but grant insufficient relief to that part of industry which works mainly with equity capital. This situation is not only undesirable from the point of view of an equitable distribution of the tax burden. The new tax relief also misses one of the main objectives of inflation adjustment, i.e. to remove the incentive to work with more borrowed funds and less own capital. Comprehensive inflation adjustment reduces the tax burden in proportion to the use of own funds in the business and thereby abolishes the incentives for working with borrowed money inherent in "non-inflation adjusted" tax systems in countries with a high rate of inflation.

Furthermore, granting tax benefits on the basis of the value of inventories on the first day of the tax year invites the adjustment of business transactions to the technicalities of tax legislation to a much higher degree than does a comprehensively inflation adjusted tax system. The above-mentioned disadvantages could be avoided by granting the inventory relief, possibly at a higher rate than 25 or 50 percent, only in respect of that part of the inventories financed by own funds.

It may be even more appropriate to grant the relief on the net working capital, thereby also compensating manufacturers who have to finance clients' debts in the same way as is done for those financing mainly inventories.

While it is appreciated that the method of granting tax relief chosen in Amendment 6 may be easier to administer and to explain, the advantages of alternative method indicated in the previous paragraphs appear to weigh strongly in their favour.

**New method of benefits for "approved enterprises" with 49 percent foreign participation**

A good example of comprehensive inflation adjustment, though restricted to the devaluation of the Isareli pound against the U.S. dollar, was introduced in Israel in March 1977 by Amendment 15 to the Law for the Encouragement of Capital Investment (Ronel amendment) under which "approved enterprises" in manufacturing industry with at least 25 percent foreign investment are entitled to opt for a devaluation-adjusted tax calculation. Under that system they adjust annual depreciation, floating assets, floating liabilities and the instalments on long term liabilities due during the tax year to the dollar rate prevailing at the end of the tax year. The difference arrived at under that adjustment is transferred partly to a capital maintenance reserve and partly to a dividend maintenance reserve with a view to preserving free of taxation the equity capital and the distributable profits, at least in terms of U.S. dollars.

The rather sophisticated procedures of the Ronel Amendment have been subject to criticism from the taxpaying public and within the administration for being too complicated. A number of proposals have been submitted to base the adjustment on the amount of equity capital and undistributed profits rather than adjusting separately the various items of assets and liabilities.

Following these proposals Amendment 17 to the Law for the Encouragement of Capital Investment offers to approved enterprises with over 49 percent foreign participation the additional option of deducting from their taxable income an allowance reflecting the inflation effect on their equity capital, including undistributed profits (in the following "equity adjustment").

It is difficult to compare the advantages of the equity adjustment with those of the Ronel amendment because the regulations which will define the meaning of paid-up share capital for the purpose of that amendment — and may also provide for certain items to be deducted from share capital for the purpose of the equity adjustment — have not yet been published. In order to obtain results as close as possible to those obtained under the Ronel amendment, investments in building plots and securities should be so deducted. (Because the present law provides for inflation adjustment of the capital gains tax upon the sale of plots and securities the absence of deduction of these items under the equity adjustment may cause some taxpayers to receive tax relief for the same items twice.)

Both the benefits under the Ronel adjustment and the equity adjustment are subject to the loss of the right for 50 percent annual depreciation on industrial machinery and of the inventory relief.

**Early interest and linking charge after reduction of tax advances**

While the equity adjustment is destined to offer a simpler alternative to the Ronel amendment, the third of the recent amendments reviewed herein goes somehow in the opposite direction — further complicating the tax law for the sake of a more equitable distribution of the tax burden.

Despite the opposition to interest being charged before the prescribed date of the submission of the tax return, Amendment 32 to the Income Tax Ordinance provides that taxpayers who applied for and were granted a reduction of their tax advances are charged with linkage (linkage means linking to the c.o.l. index) and 4 percent annual interest on the difference between the reduced tax advances and the amounts originally demanded or between the former tax and tax actually due — the lower of the two — beginning 6 months before the end of the tax year.

In principle, it appears equitable that the tax should be paid as closely as possible to the date when the income was earned. Therefore, it appears justified that the taxpayer should pay interest and linkage from the middle of the tax year onward for underpayments of tax which are due to his own action. These payments also tend to equalise the position of wage earners who have their tax deducted monthly and self employed taxpayers who pay 10 tax advances during the tax year but may underpay the tax if advances are too low.

The premium on late tax payment has nevertheless not been fully removed. Payment of interest and linkage can be deducted as an expense in future tax returns. Because the Israeli taxpayer can by investing money in Government Bonds and saving schemes earn almost the same amount of linkage and interest which he has to pay on tax debts, the tax deduction of these charges provides a certain incentive for delaying tax payments.

### Summary of inflation relief under present tax legislation

After the review of recent legal changes a summary of Israeli tax legislation vis-à-vis inflation is given below.

## 1. Tax brackets and social allowances

Tax brackets, tax credits in respect of personal allowances and social allowances are all indexed. It appears that at the long term inflation rate of close to 40 percent such indexing is unavoidable.

In any case, concerning tax brackets and social allowances authority is given to the Minister of Finance to grant, with the approval of the Finance Committee of Parliament, partial indexing only. During a large part of the period since the tax reform of July 1975 the Minister of Finance made use of that authority and reduced indexing by about one third.

## 2. Interest and linking on tax debts and tax refunds

On tax debts, interest (presently at 26 percent p.a.) is charged for the first 6 months after the end of the tax year and thereafter full c.o.l. index linkage plus 4 percent interest. On tax refunds interest and linkage are credited at the same rate.

From the tax year 1978 onward interest and linkage are charged from the middle of the tax year onward on tax debts due to the reduction, at the request of the taxpayer, of advance tax payments.

After the addition of the last mentioned measure in August 1978, the charge of interest and linkage on tax debts and their allowance on tax refunds appear comprehensive and consistent — with the exception of their tax deductibility which appears to create a windfall profit for late taxpayers.

## 3. Taxation of capital gains

With the split of capital gains between inflationary gains and real gains in 1975 the main step towards inflation adjustment of capital gains has been taken. It does not appear justified to relate the taxation of the capital gain to the dates of purchase and sale, because that method gives a benefit to those financing by borrowing. That would be avoided were the tax calculations related to payment dates.

It could be argued that the 10 percent tax rate on inflationary gains is excessive and is levied — in real terms — on capital. In view of the fiscal needs of Israel and also in comparison with other countries the restriction of the taxation of the inflationary element in capital gains appears nevetheless as a very progressive measure.

## 4. Adjustment of the measurement of business profits for inflation (tax base adjustment)

No measures have been taken to relieve the business community in general of the whole or part of the burden of the taxation of unreal profits.

But manufacturing industry has been granted substantial relief by the 50 percent annual depreciation of machinery (since 1975) and the deduction from taxable income of part of the price increases of inventories (since 1978). In view of the relatively large percentage of industrial investment financed by borrowing, it appears likely that industry on the whole in Israel will not pay more income and corporation tax in 1978 and 1979 than it would have paid on fully inflation adjusted accounts.

Certain "approved enterprises" with foreign participation have the option to choose between the two above mentioned benefits and a comprehensive adjustment for the devaluation of the Israeli pound, and in some cases the further alternative of the equity adjustment. Both options have somewhat lost importance since the introduction of the inventory relief but there is probably a number of corporations to which these options or one of them give larger benefits.

The restriction of concessions in the computation of income for tax purposes to manufacturing industry seems to be in disagreement with the principle of tax neutrality. It can, however, be explained by the fiscal needs of the country and the importance of giving an incentive to industry in view of its importance in improving the balance of payments and contributing to growth.

A more serious problem appears the absence of any inflation adjustment in the taxation of interest income and linking differences (except for tax exemption of linking differences in saving schemes, Government bonds and certain bank accounts) and their tax deductibility. The taxation of interest and linking differences means in most cases the taxation, wholly or mainly, of unreal income. Correspondingly their tax deductibility gives mostly an undue benefit because the expense is generally offset by a decline of the burden of debts in real terms.

It may, however, be difficult to change the system of taxing interest and linkage without creating new distortions as long as the tax system in Israel, though containing some provisions of inflation adjustment, is not fully adjusted for inflation.

In any case, the deductibility of interest and linkage costs appears to add to the incentives to work with borrowed funds inherent also in other provisions of the present tax system.

It should be a major objective of further changes in the Israeli tax legislation to remove two highly undesirable incentives: the incentive to delay tax payment, and the incentive to work with borrowed funds.

The measures to be taken towards achieving that objective would make the tax system more equitable and they may also tend to restrain inflation.

# CONFERENCE DIARY

## JANUARY 1979

*British Branch of I.F.A.:* Formation of Family Businesses, London (U.K.), January 9 (English).

*Marchmont Conferences:* The International Tax Planning Conference, Naussau, The Bahamas, January 10-12, 1979 (English).

*British Branch of I.F.A.:* Outward direct investment, London (U.K.), January 31 (English).

## FEBRUARY 1979

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

## MARCH 1979

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

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

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

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

## APRIL/MAY 1979

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

## JUNE 1979

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

## SEPTEMBER 1979

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

## FEBRUARY 1980

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

## SEPTEMBER 1980

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

FOR FURTHER INFORMATION PLEASE WRITE TO:

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

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

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

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

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

Marchmont Conferences, 24 Hanover Square, London WIR 9 RD (U.K.).

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

# SOME ECONOMIC EFFECTS OF THE CORPORATE PROFITS TAX:
# A theoretical appraisal with special reference to Canada

by Dr. Kempe R. Hope*

## INTRODUCTION

*The corporate profits tax [1] is regarded as a tax on the earnings of equity capital in corporate enterprises. This tax was first introduced by the Canadian Government in 1917 to raise revenue to finance the costs of World War I. Currently, this tax provides the third largest source of revenue for the Federal Government, with the personal income tax and commodity taxes being the first and second largest sources of revenue respectively. The corporation profits tax applies to all profits earned by resident and non-resident corporations carrying on business in Canada. One-half of capital gains must be included in profits.*

*Since 1962 all the provinces have enacted their own corporate profits tax. The provincial tax is levied on the same base as the federal tax. By agreement, the Federal Government collects all taxes except in Ontario and Quebec.*

*This paper will examine some of the economic effects of the corporate profits tax from a theoretical standpoint of appraisal. Before we do that, however, it may be worthwhile to elucidate the rates of taxation as they currently apply to corporations in Canada, and the revenue implications of these taxes.*

## I. TAX RATES AND REVENUE IMPLICATIONS

A flat 50 percent rate was introduced in 1972 on corporate taxable profits. This rate was reduced by one percent each year to 46 percent currently. The Federal Government permits an abatement of 10 percent on income earned in a province in order to allow the provinces room to levy their taxes. For small businesses, the current legislation provides that a Canadian controlled private corporation pay 25 percent on the first $150,000 of business profits, and the general rate on profits in excess of this amount. The legislation ensures that the low rate applies only to small business firms by stipulating that any corporation that has accumulated taxable profits of $750,000 will lose the benefits

* Assistant Professor of Economics and Finance, Daemen College, Amherst, New York.
Research for this paper was conducted in Canada during the academic year 1975-76 while the author was a Research Fellow at the University of Toronto. Appreciation is expressed to Richard Bird and Jesse Burkhead for their comments on an earlier draft which allowed me to update the paper with respect to recent amendments to Canadian tax legislation.

1. The term "corporation income tax", which is more commonly used, is erroneous. The tax base is the profit of a corporation, not its revenue.

**TABLE I**
**Canadian corporation income tax declared by taxable companies reporting a profit for selected years 1928 to 1973 ($ Million)**

| Taxation year | Number of companies | Current year taxable income | Net taxable income | Net federal taxes | Ontario and Quebec taxes | Other provinces taxes | Total taxes | Net taxable income after total taxes |
|---|---|---|---|---|---|---|---|---|
| 1928 | 7,957 | 544 | 544 | 42 | – | – | – | – |
| 1938 | 17,618 | 546 | 546 | 74 | – | – | – | – |
| 1948 | 27,997 | 1,946 | 1,932 | 588 | – | – | – | – |
| 1951 | 33,720 | 2,795 | 2,757 | 1,164 | – | – | – | – |
| 1961 | 72,290 | 3,624 | 3,505 | 1,323 | – | – | – | – |
| 1962 | 78,241 | 3,943 | 3,749 | 1,283 | – | 100 | – | – |
| 1963 | 87,310 | 4,252 | 4,017 | 1,365 | – | 104 | – | – |
| 1964 | 94,821 | 4,634 | 4,386 | 1,520 | – | 118 | – | – |
| 1965 | 78,276 | 4,669 | 4,593 | 1,572 | 355 | 115 | 2,042 | 2,553 |
| 1966 | 87,944 | 4,943 | 4,874 | 1,619 | 374 | 130 | 2,123 | 2,751 |
| 1967 | 93,562 | 5,092 | 5,017 | 1,656 | 400 | 154 | 2,210 | 2,807 |
| 1968 | 100,564 | 5,967 | 5,889 | 1,988 | 471 | 178 | 2,637 | 3,252 |
| 1969 | 107,276 | 6,754 | 6,644 | 2,290 | 520 | 204 | 3,014 | 3,630 |
| 1970 | 108,773 | 6,457 | 6,370 | 2,192 | 508 | 200 | 2,900 | 3,470 |
| 1971 | 113,979 | 7,297 | 7,160 | 2,387 | 578 | 235 | 3,200 | 3,960 |
| 1972 | 114,872 | 9,114 | 8,462 | 2,751 | 665 | 267 | 3,683 | 4,779 |
| 1973 | – | 11,886 | 10,949 | 3,499 | 836 | 396 | 4,731 | 6,218 |

–: Information not available.
*Sources:* Canadian Tax Foundation, *The National Finances (Several Issues)* (Toronto: Canadian Tax Foundation).

of the lower rate on the first $150,000. For the 1972 and 1973 taxation years this low rate was 25 percent on the first $50,000 up to a maximum of $400,000.

It was estimated that in 1977-78 the corporation profits tax will account for approximately 17 percent of total budgetary revenues. [2] Table I shows the extent to which corporation profits have been taxed by the Federal Government for selected years since 1928. For the earlier years, the tax levy took less than 10 percent of taxable profits. The combined impact of income tax and excess profits tax was more than 50 percent during the war. In the post-war years, the aggregate tax has been markedly less than 50 percent.

## II. ECONOMIC EFFECTS

### (A) Resource allocation

Because Canadian Corporations can deduct interest payments but not dividends from their taxable profits, there results a major misallocation of resources with respect to corporate financing. Corporations have an incentive to use debt financing rather than equities to pay for new investment. This incentive favours large corporations, which have better access to funds than smaller corporations. Most corporations, however, are reluctant to use debt financing, despite the fact that equity financing is much more expensive than debt financing. This is so primarily because, with a fairly stable tax treatment of interest and dividends, many firms obtained new funds in the proportions dictated by target debt-equity ratios which remain fairly stable over time. [3] Thus, apart from discriminations in favour of large corporations, the deductibility of interest fails to remove the growth disincentive of the tax.

Another misallocation problem arises through deductions for capital consumption, or capital cost as it is commonly called. Capital cost allowances provide the largest single source of investible funds for most corporations. The Income Tax Act allows corporations to write off assets at higher rates during the earlier years after acquisition than are normally applied for book purposes.

This liberalised capital cost allowance provision, which is also in effect in the United States, [4] has resulted in increased (though unevenly) capital cost allowance in relation to GNP as shown in Table 2. The objective of this capital cost allowance was primarily to stimulate domestic investment in times of economic slowdown and to provide an incentive for regional development. This was expected to occur because as depreciation allowances claimed by corporations increased, taxable income and tax liability would decrease, and corporations would have more after-tax profits than they would otherwise have. Hence, investment would rise and economic growth would be stimulated. [5] The ultimate effect would, therefore, be a substitution of capital for labour. This, however, creates capital intensity and declining trends in the relative importance of corporation tax revenues. Canada, along with the United States and Germany, is among those highly industrialised countries that have experienced a steady declining trend

**TABLE 2**
**Capital cost allowance claimed by corporations as a percentage of GNP, 1954-71**

| Year | Capital cost allowance as a percentage of GNP | Year | Capital cost allowance as a percentage of GNP |
|---|---|---|---|
| 1954 | 4.9 | 1963 | 5.2 |
| 1955 | 5.0 | 1964 | 6.1 |
| 1956 | 5.2 | 1965 | 5.9 |
| 1957 | 5.5 | 1966 | 6.2 |
| 1958 | 5.4 | 1967 | 6.0 |
| 1959 | 5.6 | 1968 | 5.4 |
| 1960 | 5.3 | 1969 | 5.6 |
| 1961 | 5.3 | 1970 | 5.7 |
| 1962 | 5.4 | 1971 | 5.6 |

*Sources:* Statistics Canada, *National Income and Expenditure Accounts*; Statistics Canada, *Corporation Taxation Statistics*; and Department of National Revenue, *Taxation Statistics - Part Two.*

in the relative importance of corporation tax revenues during periods of prosperous economic conditions. [6] Thus, the stabilisation effects of capital consumption allowances may not be as satisfactory as the allocation and economic growth effects discussed above. Furthermore, arguments have been made that it is very likely that capital consumption allowances will tend to intensify fluctuations, that is, widen the range of the cycle in terms of both output fluctuation and cycle duration. [7] These effects will occur because the capital consumption allowance will encourage investment when profits are high and tax extraction is considerable, while in the absence of profits during a downturn in the

2. See Canadian Tax Foundation, *The National Finances 1977-78* (Toronto: Canadian Tax Foundation, 1978).
3. J.F. Helliwell, *Taxation and Investment: A Study of Capital Expenditure Decisions in Large Corporations* (Ottawa: Studies of the Royal Commission on Taxation, No. 3, Queen's Printer, 1964), pp. 224-225.
4. The U.S. Tax Reform Act of 1969 reduced allowable accelerated depreciation from the rates prevailing before 1969, but corporations are still allowed to use a variety of accelerated depreciation methods. The value of accelerated depreciation is that it allows firms to postpone their tax payments, earning interest in the meantime. Thus, accelerated depreciation has the same effect as interest-free loans to producers. For more on this point, see Neil M. Singer, *Public Microeconomics* (Boston: Little Brown, 1972), pp. 148-149.
5. This proposition has been well documented theoretically. See, for example, Richard M. Bird, "Depreciation Allowances and Countercyclical Policy in the United Kingdom, 1945-60", *Canadian Tax Journal* XI (May-June 1963), pp. 253-73 and (July-August 1963), pp. 353-80; Robert H. Haveman, *The Economics of the Public Sector* (New York: Jonh Wiley), pp. 128-130; and Richard M. Bird, "Tax Incentives for Regional Development", *Proceedings of the Twenty-First Tax Conference* (Toronto: Canadian Tax Foundation, March 1969), pp. 192-199.
6. Ernst-Albrecht Conrad, "Trends in the Level of Corporate Taxation", *Finanzarchiv* N.F. 31, Heft 3 (1974), pp. 362-363.
7. See Evsey D. Domar, "The Case for Accelerated Depreciation", *Quarterly Journal of Economics* (November 1953), pp. 493-519.

economy, it will become ineffective or, even worse, it may make it worthwhile to postpone investment until profits re-appear and advantage can be taken of larger allowances.

Finally, with respect to resource allocation, there are the effects of depletion allowances. As a corporation makes use of its capital stock in the course of production, it is allowed to deduct from its taxable income an amount that supposedly represents the cost of the capital equipment used. If the capital asset is not a machine or building, but is instead an oil well or a coal mine, the firm is still allowed a deduction relative to the decline in the value of its asset. This deduction is offered under the tax law and is referred to as depletion allowances or, more popularly, as mineral depletion allowances.

Currently in Canada, there is an automatic depletion allowance of one-third of income otherwise taxable. This came to an end in 1976 and, after that, depletion was earned on the basis of $1.00 for every $3.00 spent on exploration and development (excluding land) and on investment in mining. The annual maximum claim will be one-third of income otherwise computed, subjected to carry-forward of deductions earned but not claimed. [8]

It is clear that the deplection allowance singles out a few industries for preferred treatment. This allowance grants enormous advantage to firms in the extractive industries, particularly the oil industry. In fact, depletion allowances reduce the taxes which extractive industries have to pay by a significant amount each year. It was estimated that for 1971, using a 50 percent corporate profits tax rate, the tax savings to corporations resulting from depletion allowances were in the order of $124 million. [9] One effect of such savings, of course, is that if federal revenue is to be maintained, other taxes have to be higher and other taxpayers would have to pay more taxes (the amount of the savings obtained from depletion allowances for corporations) than would otherwise be the case. This, therefore, seriously redistributes the tax burden.

But apart from the tax burden redistribution there is the effect of this allowance on the allocation of Canada's resources. Because of the subsidised profits of firms in the extractive industries, capital in excess of the economic optimum is attracted to these industries. Given that the real return on investment in excess of the optimum is very low, the depletion allowance will tend to reallocate Canada's resources from higher return uses outside the extractive industries to lower return uses in it. This will ultimately reduce the overall productivity of capital in the Canadian economy. Also of significance, and it should be mentioned here, is the fact that depletion allowances, as tax preferences, give rise to substantial horizontal inequities in the Canadian economy.

### (B) Investment

Investment is treated separately here, instead of under resource allocation, because of the complexity and importance attached to it in the current literature on the economic effects of the corporate profits tax.

It is generally asserted that the corporation profits tax has a negative or retarding effect on aggregate investment expenditures in the economy. [10] Further, this tax, as a specific tax, it is argued, results in distortions in the use of capital and changes in economic welfare. [11] Let us, therefore, examine the effects of the corporate profits tax on investment through the use of some diagrams.

Figure I shows this effect on both corporations and unincorporated business. Part I shows the ability of a corporate enterprise to offer an investor a return on his investment. This is shown by the enterprise's marginal efficiency of investment curve (MEIC) which indicates the rate of return the corporation will receive on increments in its capital stock. The investor's willingness to supply funds is dependent only on the net rate of return he expects to receive and, obviously, his supply curve is not affected by the imposition of the corporation profits tax.

Before the tax, the corporate enterprise invests $I_o$ of the investor's capital and pays him a rate of return $r_o$. After the tax is imposed, the corporation can no longer offer the investor the same rate of return. This is so simply because total profits are now reduced by the amount of the tax liability. Thus, the MEIC of the corporation will shift downward to $MEIC^o$. At this level of rates of return, the investor will be less willing to invest in the corporation and he will reduce his level of lending to $I_1$ where the rate of return is $r_1$. The impact of the profits tax on investment is dependent primarily on two things. One is the tax rate, and the second is the interest elasticity of the investor's supply curve. Unless the investor's supply schedule is perfectly inelastic, the decrease in profits from investment will induce him to cut back on his supply of funds to the business enterprise.

Part II shows what tends to occur in the non-corporate sector when a profits tax is applied to the corporate sector. The profits of non-corporate investment are not affected by the corporation profits tax. The MEIC curve for the non-corporate sector, therefore, tends not to shift as a result of the tax. However, the reduction in the rate of return that investors can earn in the corporate sector may influence them to supply funds to the non-corporate sector. Therefore, investors may increase their supply to non-corporate enterprises from $S_o$ to $S_1$. The level of non-corporate investment would accordingly rise from $I_o$ to $I_1$ where the rate of return is exactly equal to the rate of return in the corporate sector.

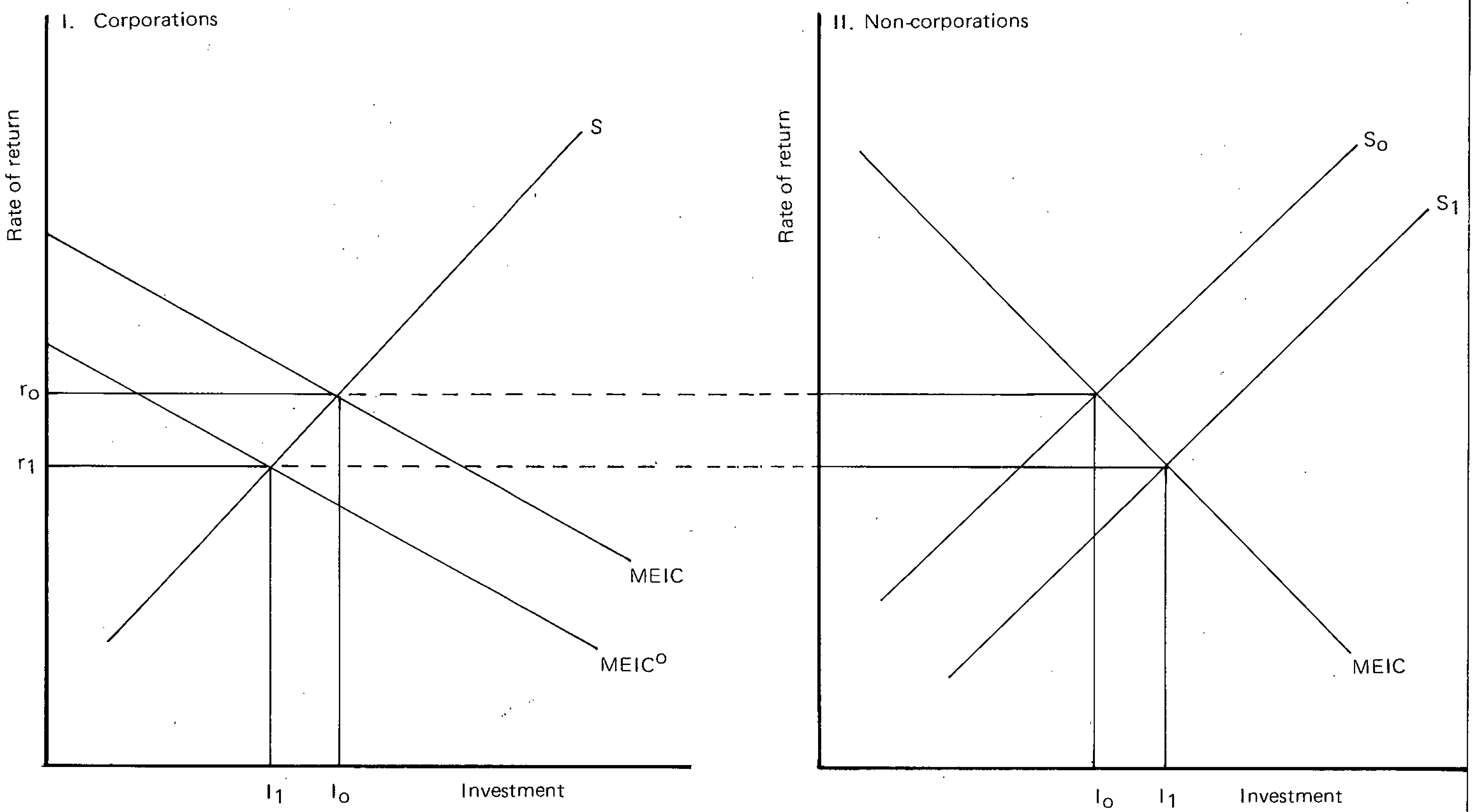
8. See M. Bucovetsky and R.M. Bird, "Tax Reform in Canada: A Progress Report", *National Tax Journal* 25 (March 1972), pp. 15-41.

9. Statistics Canada, *Corporation Taxation Statistics 1971* (Ottawa: Information Canada, April 1974), p. 32.

10. Bernard P. Herber, *Modern Public Finance* (Homewood: Richard D. Irwin, Third Edition, 1975), p. 230.

11. See Arnold C. Harberger, "Three Basic Postulates for Applied Welfare Ecomomics: An Interpretative Essay", *Journal of Economic Literature* 9 (September 1971), pp. 785-797.

**FIGURE I: Effect of corporation profits tax on investment**




The occurrence of such a situation represents a misallocation and waste of society's resources. Investment projects that are socially profitable in the corporate sector are not carried out in favour of profits that are less socially profitable in the non-corporate sector, and the overall reduction in investment results in a lower growth rate. However, the prices of goods produced by the corporate sector, which uses large amounts of equity capital, will rise relative to those of goods produced in the non-corporate sector. This has some welfare implications; specifically, a welfare loss to consumers since their marginal rates of substitution are not equated with even the distorted marginal rate of transformation.

The above analysis and the results, which have become very popular in public finance texts, have resulted in the advocacy in some academic circles of replacing the corporate profits tax with a uniform tax of equal yield on the return to capital from all sources. [12] Professor John Bossons has deduced that the gain in efficiency terms from the application of a neutral tax on capital income would have amounted to approximately a $500 million increase in the output of the Canadian economy at 1970 prices. [13] Otherwise, no attempts have been made to examine empirically the gains from a neutral tax nor of the effects of the corporate profits tax on investment in the Canadian economy. A number of these studies have, however, been done on the American economy [14] and it may be worthwhile to advocate here that such studies be attempted for the Canadian economy.

Recent studies on corporate profits tax have argued that there is great interdependence between the level of corporate investment and its financing. [15] Hence, in investigating the effects of corporate taxation, the investment decision should not be studied in isolation from the financing decision and, therefore, not through the estimation of aggregate investment functions but through a simultaneous econometric model.

Other studies have advocated that direct tests be made on the influence of tax policy within a flexible version of the neo-classical model. [16] This can be done by using a constant elasticity-of-substitution production

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12. See, for example, Arnold C. Harberger, "The Corporation Income Tax: An Empirical Appraisal" in *Tax Revision Compendium* (Washington, D.C.: U.S. House of Representatives, Ways and Means Committee, 1959), pp. 231-50.
13. John Bossons, "The Impact of Tax Rates on the Effect of Tax Reform", *Proceedings of the Twenty-Second Tax Conference* (Toronto: Canadian Tax Foundation, 1970), pp. 26-59.
14. For a good summary of the literature pertaining to the United States, see OECD, *Theoretical and Empirical Aspects of Corporate Taxation* (Paris: OECD, 1974), pp. 57-63.
15. See, for example, OECD, *Theoretical and Empirical Aspects of Corporate Taxation* (Paris: OECD, 1974).
16. See M.S. Feldstein and J.S. Flemming, "Tax Policy, Corporate Savings and Investment in Britain", *Review of Economic Studies* 38 (October 1971), pp. 415-34.

function, which is more flexible than the unitary-elasticity model used by Hall and Jorgenson.[17] In the direct tests model, the cost of the capital variable follows the neo-classical assumptions but allowance is made for different elasticities with respect to each component.

But irrespective of the model used, economic studies have seemingly been unable to resolve, in a definitive manner, the issue of the effects of taxation on the level and structure of business investment. Policy makers have, therefore, been short-changed. The issue seems not to be what the effects are but, rather, how great the effects are likely to be in the long run and how quickly they will develop in the short run. These are the two major currently unsettled questions.[18]

## (C) Savings

From the foregoing discussion on investment, it seems as though David Walker may have been correct when he wrote *"it is not possible for any statistical study to tell the whole story about the effects of company taxation on the levels and prices of investment"*.[19] While statistical and empirical analysis cannot help us to arrive at any definite or final conclusion about the effects of the profits tax on investment decisions, it is possible to examine the impact of corporate taxation upon the level of corporate savings.

It has been noted that the level of internal corporate funds in Canada is very high.[20] This is due primarily to, and as mentioned in an earlier section of this paper, generous capital cost allowances. These allowances have made it possible for corporations to set aside large amounts of funds. Also, before 1972, there was no tax on capital gains and this provided an incentive for companies to pay out a smaller percentage of their earnings as dividends and to retain a larger percentage as undistributed profits. This incentive was derived from the fact that undistributed profits owned by upper income shareholders were subject to the corporate tax rate which was lower than the personal rate that would have been paid if the profits had been paid out in dividends. It was, therefore, to the advantage of these shareholders to realise on the profits of the corporations through the means of capital gains and by so doing avoid the full burden of personal income taxes.

Whether the effects of corporate taxation on the availability of funds are significant would hinge on whether the corporate sector is or is not able to shift its tax burden to the consumers in the form of prices. The current state of the literature on the shifting of the corporate profits tax is in a state of uncertainty — to say the least. The true corporate tax incidence pattern, however, probably contains a mixture in unknown proportions of all the plausible group burdens.[21] One Canadian study has found evidence of forward shifting of the Canadian corporate profits tax primarily in industries characterised by a high degree of monopoly.[22] To the extent that there is forward shifting of the tax, the financial resources available to companies out of non-distributed profits are not affected.

## (D) International considerations

International considerations are playing an important part in influencing the choice of governments as to which tax system should be adopted. Specifically, these considerations pertain to the impact of a system upon the balance of private capital transactions, upon the form of direct private investment from abroad, and upon the government's share of revenue from international investment income arising within its borders or accruing to its residents.

Basically, there are four methods of taxing corporate and shareholders' income.[23] These are (i) the separate entity system, (ii) the split-rate system, (iii) the imputation system, and (iv) the fully integrated system.

The *separate entity system* is regarded as the simplest form of corporate taxation. Here, the corporation tax and the personal income tax are applied independently of each other. Usually, a flat rate is imposed on the entire pool of corporate profits, whether retained or distributed, and distributed profits are then taxed at the shareholder level as personal income tax.

The *split-rate system* applies a lower rate of tax on dividends than on non-distributed profits. Hence, non-resident portfolio investors benefit automatically from it in the same way as resident investors. A split-rate system would, therefore, tend to attract non-resident capital.

The *imputation system* or dividend credit system, as it is sometimes called, gives distribution relief at the shareholder level only. Corporations are taxed at a flat rate on all profits, whether distributed or not, but shareholders are entitled to credit a part or all of the corporation tax attributed to their dividends against their personal income tax on those dividends.

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17. See R.E. Hall and D.W. Jorgenson, "Application of the Theory of Optimal Capital Accumulation" in Gary Gromm (ed.), *Tax Incentives and Capital Spending* (Washington, D.C.: The Brookings Institution, 1971).
18. George F. Break, "The Incidence and Economic Effects of Taxation" in Alan S. Blinder et al., *The Economics of Public Finance* (Washington, D.C.: The Brookings Institution, 1974), p. 219.
19. David Walker, "Some Economic Aspects of the Taxation of Companies", *The Manchester School of Economic and Social Studies* 22 (January 1954), pp. 1-36.
20. D.A.L. Auld and F.C. Miller, *Principles of Public Finance: A Canadian Text* (Toronto: Methuen Publications, 1975), p. 121.
21. George F. Break, "The Incidence and Economic Effects of Taxation", in Alan Blinder et al., *The Economics of Public Finance* (Washington, D.C.: Brookings Institution, 1974) p. 153.
22. See R.J. Levesque, *The Shifting of the Corporation Income Tax in the Short Run* (Ottawa: Studies of the Royal Commission on Taxation, No. 18, Queen's Printer, 1967).
23. For a thorough exposition of these methods see Mitsuo Sato and Richard Bird, "International Aspects of the Taxation of Corporations, *IMF Staff Papers* 22 (July 1975), pp. 384-455; and OECD, *Company Tax Systems in OECD Member Countries* (Paris: OECD, 1973), pp. 24-29.

The *full integration system* seeks to integrate the personal income tax with the corporation profits tax. This type of system is very difficult to implement and would require a significant reform of the tax administration bodies in most countries. The usual manner in which this system is advocated is that of taxing corporations at a uniform level while shareholders are subject to personal income tax on both dividends received and the share of undistributed profits allocated to them. However, shareholders are entitled to a full credit of corporation tax against personal income tax due on dividends and the allocated share of grossed-up retentions. The amount of this credit exceeding the personal income tax is then to be refunded to the shareholder.

Currently in Canada, there is what can be regarded as a partial integration scheme. The scheme provides for a 50 percent gross-up and credit for dividends. This scheme is, however, not as equitable as the full integration scheme proposed by the Carter Commission. [24] Moreover, in contrast to the Carter proposals, the scheme does not provide equal treatment for retentions and dividends. [25]

However, there seem to be two major arguments in favour of the current partial integration scheme. [26] Firstly, it is argued that this system satisfies, more easily, the requirements of international tax neutrality and, secondly, the desire of Canada not to extend integration benefits or dividend credit to foreign investors finds some support from the criterion of intercountry equity; this being so, since it is not appropriate to extend such distribution relief across the border unless capital-exporting countries extend a comparable relief to Canadian investors in their countries.

## III. CONCLUSION

This paper has appraised, from a theoretical standpoint, some economic effects of the corporate profits tax. For the practical aspects, we have case-studied Canada. It is hoped, therefore, that some light has been shed on the issues involved in the analysis of economic effects of the profits tax, and, more so, with respect to Canada.

On efficiency and equity grounds, the corporate profits tax has been subject to far more criticism than the personal income tax. The personal income tax seems to be an internationally accepted phenomenon while even the reasons for taxing corporations are still being debated by economists and politicians. Due to space limitations, I will not go into any of those issues here nor will I end my work with a call for more research in specific areas. I have already done that in some parts of this paper. Moreover, the issues are rather clear, particularly with respect to the Canadian corporation profits tax.

24. See *Royal Commission on Taxation Report*, Volume 4, Chapter 19 (Ottawa: Queen's Printer, 1966).
25. For an analysis of the tax treatment of dividends in Canada, see Edwin C. Harris, "The Tax Treatment of Dividends in Canada", *Bulletin for International Fiscal Documentation* 28 (February, 1974), pp. 67-76.
26. See Mitsuo Sato and Richard Bird, "International Aspects of the Taxation of Corporations and Shareholders", pp. 439-444.

# United States:

## Taxation of U.S. Real Estate Owned by Non-Resident Aliens

Under the Finance Act 1978 of the U.S.A., the Treasury Department must prepare a study on the taxation of foreign owners of U.S. real estate. This study must be submitted to the Senate Finance Committee and the House Ways and Means Committee within 6 months after the Finance Act 1978 has been enacted.[1] The study will investigate whether the present taxation is justifiable, and if not, to what extent the Internal Revenue Code and certain tax treaties should be modified.
At present, non-residents, not engaged in business in the U.S.A. who invest in U.S. the gross income from real estate, but capital gains are not subject to tax. These real property are subject to a 30% tax on non-resident real estate owners may elect, however, to be taxed as if such income from real estate were business income, i.e. to be taxed at the normal income tax rates (for individuals or corporations), but in this case capital gains are subject to tax. Under the Internal Revenue Code, non-residents who have elected for the last-mentioned method of taxation must continue to do so, except that it may be revoked with the consent of the Secretary with respect to any taxable year. In many tax treaties, however, the owner of U.S. real estate may each year choose the tax regime that is most favourable for him for that particular year, and the consent of the Secretary is not required.

Among the tax treaties under which a free choice is granted for each tax year are the tax treaties with Switzerland, the Netherlands and the Nederlands Antilles.

Residents of these countries can elect to be taxed at normal rates on net income in the years of exploitation or construction of the real estate. If such investment is financed with loans the net income often is minimal. For the year in which the property will be sold, the investor will elect a tax of 30% on gross income, while the capital gains are free from tax. Through this procedure, the U.S. tax can, to a large extent, be avoided.

Because more and more foreign investors are interested in buying U.S. real property, this issue has become rather important.

1. October 15, 1978.

## Transfer of Foreign Branch: Initial Losses*

Advice has been requested whether the transaction described below is one for which a favouable ruling will be issued under section 367 of the Internal Revenue Code of 1954.

P is a domestic corporation that is engaged in the manufacture and sale of plastic components for the radio and television industries in the United States. In 1975 P commenced business operations in country A. For various business reasons these operations were carried on by a branch that P established in country A by the transfer of cash and newly purchased assets with a value of $100x.

Beginning in 1975, deductions were taken by P under section 167 and certain other sections of the Code for expenses incurred by the branch operations. The income and losses of P and its country A branch for the years 1975, 1976, and 1977, were as follows:

| | U.S. Source Income | Country A Branch Income |
|---|---|---|
| Taxable Income in 1975 | $1,000x | ($50x) |
| Taxable Income in 1976 | $1,200x | ($30x) |
| Taxable Income in 1977 | $1,000x | ($10x) |

During each of the three years P's other foreign branches received income in excess of the losses of the branch in country A.

In late 1977, P transferred the assets of branch A to a corporation newly created under the laws of country A solely in exchange for its stock. The foreign transferee was not to be engaged in a trade or business in the United States within the meaning of section 864 of the Code and was to have no income from sources within the United States within the meaning of section 861. The transfer of assets in exchange for stock would have fulfilled all the requirements of section 351 had the transferee been a domestic corporation. Furthermore, the transfer met the requirements of section 3.02(1) of Rev. Proc. 68-23, 1968-1 C.B. 821. Within 183 days of the beginning of the transfer P requested a ruling from the Internal Revenue Service that the transaction was not in pursuance of a plan of tax avoidance within the meaning of section 367.

Section 351 of the Code provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 358 of the Code provides that in the case of an exchange to which section 351 applies, the basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged (A) decreased by (i) the fair market value of any other property (except money) received by the taxpayer; (ii) the amount of any money received by the taxpayer; and (iii) the amount of loss to the taxpayer that was recognized on such exchange, and (B) increased by the amount of gain to the taxpayer that was recognized on such exchange (not including any portion of such gain that was treated as a dividend).

Section 362(a) of the Code provides that if property was acquired on or after June 22, 1954, by a corporation in connection with a transaction to which section 351 applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

Section 367(a)(1) of the Code provides that if, in connection with any exchange

* Rev. Rul. 78-201.

described in section 351, there is a transfer of property (other than stock or securities of a foreign corporation that is a party to the reorganization) by a United States person to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on such transfer, a foreign corporation shall not be considered to be a corporation unless, pursuant to a request filed not later than the close of the 183rd day after the beginning of such transfer (and filed in such form and manner as may be prescribed by regulations by the Secretary), it is established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Rev. Proc. 68-23 sets forth guidelines for taxpayers and their representatives in connection with requests for rulings required under section 367 of the Code in respect of certain types of transactions involving foreign corporations. Section 3.02 (1) of Rev. Proc. 68-23 relates to transfers to foreign corporations controlled by domestic transferors and provides that such a transfer of property will ordinarily receive favorable consideration where the transferred property is to be devoted by the transferee foreign corporation to the active conduct, in any foreign country, of a trade or business. It is contemplated that the transferee foreign corporation, in addition to the active conduct of a trade or business, will have need for a substantial investment in fixed assets in such business.

Section 2.02 of Rev. Proc. 68-23 provides however, that in reviewing each request for ruling to determine whether a favorable section 367 ruling should be issued under the guidelines, the Service reserves the right to issue an adverse ruling if, based on all the facts and circumstances of a case, it is determined that the taxpayer has not established that tax avoidance is not one of the principal purposes of the transaction.

The losses incurred by the foreign branch operations prior to its incorporation were taken into account by P and reduced the amount of P's world-wide income subject to Federal income tax. However, as a result of the incorporation of the foreign branch operations, the income to be produced by these operations will not be taken into account by P and, thus, will not increase the amount of P's worldwide income subject to Federal income tax. Therefore, the transfer by P of the assets of the branch to the foreign corporation will be deemed to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of section 367 of the Code. Accordingly, the transfer by P of the assets of branch A to the foreign corporation will be deemed not to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, within the meaning of section 367 of the Code, only if the transferor, P, recognizes as gain on the transfer an amount of ordinary foreign source income equal to the sum of the Country A branch losses previously incurred (that is, \$90x). This income must be recognized as ordinary income by P for its taxable year in which the transfer occurred.

In addition, because the transaction qualifies as an exchange to which section 351 of the Code applies, pursuant to section 352(a) the basis of the assets transferred will be the same as the basis of such assets in the hands of P immediately prior to the exchange, increased by the amount of gain recognized to P on the transfer. Pursuant to section 358(a)(1), the basis of the stock of the foreign subsidiary received by P will be the same as the basis of the assets transferred in exchange therefor increased by the amount of gain recognized to P on the transfer.

# Reciprocal Exemption of International Transportation Companies*

**An exemption from tax on gross profits granted by Taiwan satisfies the conditions for reciprocal exemption in the United States.**

## ISSUE

Does the rationale of Rev. Rul. 73-79 correctly limit the meaning of the term "earnings" under section 883 of the Internal Revenue Code of 1954 to the meaning of the term "income" under section 901 ?

## FACTS

The Internal Revenue Service has given further consideration to Rev. Rul. 73-69, 1973-1 C.B. 340, which holds that the Republic of China does not satisfy the equivalent exemption requirement of section 883(a)(1) of the Code. This holding is predicated on the assumption that a withholding tax imposed by the Republic of China on certain international transportation companies is an income tax within the meaning of section 901.

Under Articles 25(3) and 88(6) of the Income Tax Law of the Republic of China, international transportation enterprises with neither a business agent nor a branch office in Taiwan are taxed on a percentage of gross receipts received for outward-bound freight or passengers. The Articles make no allowance for the deduction of expenses in computing this "tax".

## LAW AND ANALYSIS

The applicable sections of the Code and Income Tax Regulations are 883(a)(1) and 1.883-1(a)(2)(i), relating to exclusions from gross income of foreign corporations, and 901(b), relating to credits allowed for taxes imposed by foreign countries.

Under section 883(a)(1) of the Code, earnings derived from the operation of foreign ships by foreign corporations are excluded from the gross income of such corporations and are exempt from United States taxation if the foreign countries from which the foreign ships receive their documentation grant an equivalent exemption to United States ships.

In order for section 883 of the Code to be applicable, section 1.883-1(a)(2)(i) of the regulations requires that a foreign country that imposes an income tax must exempt from taxation the income of a corporation organized in the United States that is derived from the operation of a ship documented under the laws of the United States. If no income tax is levied, then the foreign country is presumed to have granted an equivalent exemption.

Although section 1.883-1(a)(2)(i) of the regulations uses the term "income tax", section 883(a)(1) of the code refers to an equivalent exemption granted with respect to "earnings". The Service implied in Rev. Rul. 73-69 that section 1.883-1(a)(2)(i) has incorporated the standards of section

* Revenue Ruling 78-355.

901 in determining whether an exemption is equivalent. Under section 901, unless a foreign tax is almost certain of falling on net gain, it will not qualify as an "income tax" and, therefore, the tax imposed under Articles 25(3) and 88(6) does not qualify as an income tax within the meaning of section 901. See Rev. Rul. 78-61, 1978-8 I.R.B. 11.

There is no indication that Congress intended the equivalent exemption on "earnings" to be limited to foreign income taxes that would qualify for a credit under section 901 of the Code. Section 883 was enacted to eliminate double taxation on earnings by encouraging the international adoption of uniform tax laws affecting shipping companies. *S. Rep. No. 275*, 67th Cong., 1st Sess. (1921), 1939-1 (Part 2) C.B. 181. 191. Because the exemption granted by the Uinted States under section 883 is with respect to *earnings*, it follows that a foreign government must grant an exemption to United States taxpayers from taxation of their earnings if such exemption is to be equivalent and therefore come within the meaning of section 883 of the Code.

If the net gain concept of section 901 of the Code is applied to section 883, the Republic of China could impose a tax on the gross earnings of U.S. shipping firms under Articles 25(3) and 88(6), while Republic of China shipping firms would still be exempt from United States taxes because the Republic of China would not be imposing an income tax in the section 901 sense. This result is inconsistent with the purpose of section 883 which applies to an equivalent exemption from tax on earnings, regardless of whether the tax qualifies for a credit under section 901.

### HOLDING

The type of tax contemplated by section 883 of the Code is not limited to an "income tax" within the meaning of section 901(b) and may encompass a tax that does not qualify as a section 901(b) income tax, provided that such tax is a tax on earnings. Rev. Rul. 73-69 is modified to remove the contrary implication.

# TAX GLOSSARY

by H.W.T. PEPPER *

**GAINS TAX** — See CAPITAL GAINS TAX.

**GAMBLING TAXATION** — See GAMING DUTIES AND TAXES.

**GAMING DUTIES AND TAXES** — Taxation levied on the various forms of gaming and betting. In Britain such taxation includes duties on betting, e.g., on horse and greyhound racing, whether with on-course bookmakers, off-course betting shops, or totalisators, pools duty, and duties on establishments where other types of gambling take place, and specific annual levies on gaming machines. (See also FOOTBALL POOLS TAXATION, BETTING TAXES, CASINO TAX, POOLS DUTY.)

**GAMING MACHINE** — A mechanical device, usually operated by coins or purchased metal tokens, whereby a person may engage in a game of chance. Apart from the profits from the operation of the machine being taxed upon the proprietor, some countries levy sales tax or VAT upon the gross receipts, and the proprietor often has to pay an annual licence or other levy for the right to operate the machine, the licence being also a method by which the taxing authority may control the use of such machines.

**GARNISHEE ORDER** — A legal device, sometimes used in tax collection, whereby the collector may obtain an order permitting the collection of tax from assets or income of the defaulter other than those upon which the tax itself is based, in cases where there is neglect or refusal to pay tax legally due.

**GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)** — GATT is an agreement between a member of trading countries "acknowledging that their relations in the field of trade and economic endeavour should be conducted with a view to ensuring a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods".
The signatories seek to attain the objectives "by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce". In general, the agreement prohibits the use of various restrictive or discriminatory practices by governments, but also provides some latitude for countries, particularly those in the developing world, with balance of payments problems.

**GERUISLOZE OVERDRACHT** — (Holland) Transfers of a business without attracting income tax.

**GESELLSCHAFT** — (Austria, Germany) Company.

**GESELLSCHAFTSTEUER** — (Austria, Germany) Tax on subscribed corporate capital.

**GEWERBESTEUER** — (Austria, Germany) Business tax.

**GEWINNERMITTLUNG** — (Austria, Germany) Computation of business income for tax purposes.

**GEWINNAUSSCHÜTTUNG** — (Austria, Germany) Dividend distribution. BERÜCKSICHTIGUNGSFÄHIGE AUSSCHÜTTUNG is that part of company income which is distributed and which benefits from the reduced rate of corporate income tax. VERDECKTE GEWINNAUSSCHÜTTUNG is disguised dividend distribution.

**GIFTS INTER VIVOS** — Because gifts by a taxpayer to other persons during his lifetime may reduce his liability to wealth taxation and income tax while he lives or to death duties when he dies, two types of measures have been applied by various countries in order to recover some of the tax revenue that would otherwise be lost by such transfers. One procedure is to levy GIFT TAXES (q.v.) or donation duties on the amount transferred; the alternative approach is to aggregate such gifts inter vivos when they have taken place within a certain period preceding the date of death. In Britain, the period for aggregation under ESTATE DUTY was initially 3 years, subsequently 5 years, and ultimately 7 years. Estate duty is now being phased out and under CAPITAL TRANSFER TAX aggregation takes place only for the 3 years before death. To earlier transfers a lower rate of tax (equivalent to GIFT TAX, q.v.) applies. Under aggregation, the added items will be taxable at the higher graduated rates applicable to the estate as a whole.

**GIFT TAX** — A graduated tax, usually in the form of an anticipatory estate or succession duty, but at lower rates, is commonly charged at graduated rates on gifts made during the fiscal year. It is usual to provide for an annual exemption of the total gifts made up to a certain limit, and also to provide a cumulative "lifetime" exemption so as to remove possible inequity in cases where gifts may be "bunched" into a few years while no gifts are made in other years. Gifts made on the occasion of or in anticipation of the marriage of the taxpayer's children are often exempted from gift tax. Where gifts are made within a short time before death (possibly in anticipation of death) the tax law may provide that such gifts should be aggregated within the total estate of the deceased person and subjected instead to death duties which, in general, will be at a somewhat higher rate than the rates of gift tax. (See also GIFTS INTER VIVOS.) As regards the philosophy of a gift tax, while it is used as an anti-avoidance measure in conjunction with death duties, since the latter levy is intended as a method of re-distributing wealth, it has been argued that such a tax strikes at the voluntary efforts of the taxpayer to achieve redistribution by at least a partial distribution of his wealth during his lifetime! This paradox also, of course, applies to anti-avoidance taxation of inter vivos gifts as a feature of death duties.

**GO GO FUND** — A form of INVESTMENT TRUST (q.v.) in which the management, by judicious and often fairly frequent changes in the securities held, hope to achieve better than average

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

capital growth in the value of the investors' shares in the fund.

**GOING CONCERN** — A business which is actually operating, e.g., at the time of take-over. The advantage of taking over a business as a going concern (if it is operating profitably) is usually recognised by a payment for GOODWILL (q.v.) as well as for tangible assets, by the purchaser, and the latter may also qualify for relief for losses previously incurred by the business taken over if he continues to run it as before.

**GOLDEN BOWLER** — The term used in Britain to refer to the compensation or redundancy pay (which may be exempt from income tax) granted in particular to members of the Armed Forces at a time of unexpected staff reductions, e.g., in connection with a disarmament programme. The term "bowler" refers to the hat at one time commonly worn by those working in towns and cities, in contrast to the headgear worn by those in the Services.

**GOLDEN HANDSHAKE** — The tax avoidance device whereby a director of a company is compensated for the loss of his directorship in a company in which he and his associates jointly exercise control is known as a "golden handshake". The transaction may be "artificial" in that there is no actual loss to the taxpayer because he can obtain a similar appointment in some other enterprise which is also within his own or his associates' control. There has been anti-avoidance tax legislation directed at this device in Britain and other countries. Generally speaking, such legislation limits the exemption normally given under ordinary tax principles to "compensation for loss of office or employment" to a moderate ceiling figure, which may only be modified where the tax authorities are satisfied there is a genuine loss of career.

**GŌMEI-KAISHA** — (Japan) Unlimited partnership.

**GOODS RETURNED** — Where goods have been sold or delivered and the transaction entered in the books as one which attracts sales tax or helps to create a profit which is subjected to income tax, a deduction is normally made for tax purposes if the goods are subsequently returned such that the transaction, in effect, has been cancelled.

**GOODWILL** — The intangible asset which a business has, consisting of its customers and their "custom", i.e., their habit of going to a particular firm, with which they may have been long acquainted, for certain goods and services. On the sale of a business, the value attached to "goodwill" has been defined as a payment for the prospect "that the old customers will resort to the old place". The valuation of goodwill for tax purposes may create difficulty.

**GŌSHI-KAISHA** — (Japan) Limited partnership.

**GOURLEY PRINCIPLE** — A principal, established in Britain (Gourley v. British Transport Commission, 1955 3 All E.R. 796 H.L.), whereby compensation payable for loss of earnings, e.g., through injury, should be computed making allowance for the tax which would have been payable on the earnings had they been duly earned.

**GRACE PERIOD FOR TAX PAYMENTS** — Although taxes are normally made due on fixed dates, a period of grace following the date is often granted such that legal action for recovery will not be instituted before the expiry of the grace period, and interest on overdue tax will not commence to run until that period has expired. Strict equity would demand that all taxpayers should pay their tax precisely on the same date, but in practice tax administrations are not averse to some spreading of the payments over a period, which makes it easier to handle the work of recording the payments and issuing receipts where necessary. Some countries deliberately stagger payment dates within a period when payments are expected by dividing the taxpayers into alphabetical or numerical groups, each of which has to pay within, say, a week or 10-day period during a particular month.

**GRADUATED POLL TAX** — A tax levied on individuals, generally with some graduation of rates and with a ceiling inserted at a fairly moderate level, in some countries (notably East Africa) as a means of providing local revenue. The tax is usually payable by those below the ordinary income tax limits (and above a certain absolute minimum) but it is also payable by income taxpayers who, however, may be granted an offset for the tax as a deduction from their income tax liability.

**GRADUATES TAX** — A tax in some form on graduates has sometimes been proposed to recover some of the money devoted by the State to their education to a level well above that of the population as a whole. The cost comes out of general taxation, but the graduate is enabled to earn an income well above the average level of earnings and thus the means, apart from, perhaps, the moral duty to pay something back to the community for the privilege of (often free) higher education. In practice, proposals rarely come to anything, no doubt because of the vast complexity involved in trying to equate different types of cases. (See also ACADEMIC TAX.)

**GRADUATION** — It is normal to graduate taxes on income and wealth on the grounds that the marginal utility of additional layers of income and wealth constantly decreases (and taxable capacity correspondingly increases) so that a larger proportion of tax may be taken from successive slabs or slices of income or capital. The principle of graduation or "progression" can only be partially applied to indirect taxes, e.g., by taxing luxuries more heavily than semi-luxuries, and those in turn more heavily than goods in general consumption with perhaps total exemption for the barest necessities of life. (See also "D" SCHEME.)

**GRESHAM'S LAW (OF TAX PRACTICE)** — A "law" expressed by Sir Thomas Gresham in Britain, to the effect that, in conditions where the currency was debased by "clipping" or "sweating", that "bad money drives out good", i.e., that people try to pass on their more dubious coins and retain the good ones. Gresham's Law was invoked by a Commission on Tax Policy (1970-71) of the New York Bar Association reporting in 1972 (May). The Committee were making the point that when the tax laws became unduly complex, the public could not understand them, and tax administrators were unable to administer them adequately. In these circumstances the less honest tax practitioners would indulge in more dubious practices to benefit their clients in reasonable hopes of avoiding penalties. The "bad" practitioners would therefore tend to drive out the "good" ones.

**GROSS INCOME, TAXES ON** — In some countries taxes are levied on gross income (usually at low rates) without deduction for expenses, etc. Such taxes may be justified on the grounds of administrative simplicity but in general are being superseded either by sales taxes on gross turnover, which are intended as consumption taxes to be borne by the consumer, or by income taxes on net income. Withholding taxes on such items as patent and copyright royalties may amount to a "GROSS RECEIPTS TAX" where there is no provision for recognising any expenses incurred by the recipient in generating the royalties.

[to be continued]

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# List of Authors

# INDEX 1978